

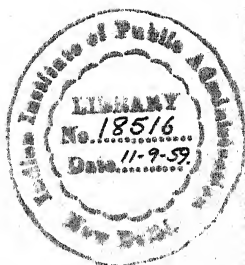
FINANCING THE WAR

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Symposium conducted by the
TAX INSTITUTE
December 1-2, 1941, Philadelphia



The Tax Institute is integrated with the
WHARTON SCHOOL OF FINANCE AND COMMERCE
UNIVERSITY OF PENNSYLVANIA

TAX INSTITUTE
PHILADELPHIA

1/12/42

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PRINTED IN THE UNITED STATES OF AMERICA
BY J. J. LITTLE & IVES COMPANY, NEW YORK

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FOREWORD

No PUBLIC finance discussion could be more timely than *Financing the War*, the subject matter of the Tax Institute's current symposium published in this volume. Moreover, the caliber of the authors who have collaborated and the care with which each has done the job he tackled will be a basis for reader satisfaction.

The conception of this series of discussions differs substantially from that of other materials, such as the issue of the *Annals* and the Alabama and Iowa State College volumes, devoted to kindred issues. The first part involves an attempt to show the amount, character, and implications of federal fiscal activity. Probably economic analysis of the government's finances has ordinarily been conceived too narrowly. At any rate, the authors speaking to the first session of the conference undertook to explore the field realistically.

Because the new excess profits tax represents a far-reaching departure from immediately past American taxation policy, the general fiscal picture would be incomplete without consideration of the effects of this measure. The masterful presentation of major results by one of the outstanding authorities should be suggestive to business men and to policy-makers alike.

Another phase of the discussion is devoted to the larger economic implications of war finance and to means of easing the impact of taxes necessarily of great severity. Two sessions were concerned with fiscal programming in relation to prices, and one session was directed specifically toward the search for policies to mitigate the hardships for

individual taxpayers. Here, again, the approach was generally that of promoting the public welfare—an approach one has learned to expect as an essential element in Tax Institute publications. The reader will, however, find here extreme variations in viewpoint. Whether the speaker's social philosophy leads to a rightist or to an opposite emphasis, the discussion provides the thoughtful with ideas.

A final element in the over-all conception of the symposium plan is found in several papers devoted to tariffs and international relations. This aspect of taxation, ordinarily much neglected by tax students, appears to have great long-range bearing on public well-being. The analysis reported here, it is believed, contributes important exploration necessary to develop sound policy following defeat of the Axis.

In consideration of war finance policy, irrespective of the particular point of emphasis, it is believed that experience elsewhere must be given careful study. Thus, this volume would be incomplete without consideration of other countries' experiences. It is peculiarly fortunate, since this part of the program could in no event be exhaustive, that the Institute could have the collaboration of three internationally known experts on German, British, and Canadian finance.

The Institute is much indebted to the contributors of these papers. The Program Committee consisted of Alfred G. Buehler, University of Pennsylvania; Beardsley Ruml, Treasurer, R. H. Macy and Company; and myself as Chairman; with Harold S. Bottenheim, Editor, *The American City*; Alfred H. Williams, President, Federal Reserve Bank of Philadelphia; and Mabel L. Walker, as ex-officio members. Special program assistance was received from Harold M. Groves, University of Wisconsin; William H. Schubart,

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Vice-president, Bank of Manhattan Company; Casimir Sienkiewicz, Vice-president, Federal Reserve Bank of Philadelphia; and numerous other persons. Special thanks are due to Thomas S. Gates, President, University of Pennsylvania; Randolph Paul, Lord, Day and Lord; Frederick L. Bird, Dun and Bradstreet; Ernest Minor Patterson, University of Pennsylvania; and George S. Patterson, George H. McFadden and Brother; who, in addition to some of the Program Committee members, participated in the program by presiding or performing similar functions.

The Committee on Local Arrangements, under the Chairmanship of Senator Franklin S. Edmonds, cooperated helpfully in the conduct of the symposium.

JAMES W. MARTIN,
Chairman,
Program Committee

University of Kentucky
January, 1942

PART ONE

SURVEYING FEDERAL FINANCES

CHAPTER I

FUNCTION AND SCOPE OF WAR FINANCE

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THE FUNCTION of war finance is the distribution of the national income. Its scope is much broader, and its task more complicated than merely "paying for the war," or "paying for defense." Indeed, its principal concern may be that part of the national money income which is not utilized directly for the military program. War finance is the pecuniary counterpart of the war economy; and, in proportion to the extent of the military effort, the scope of war finance will be widened.

OBJECTIVES OF WAR FINANCE

In addition to its task of financing the military effort, war finance must concern itself with two objectives. It must effect this distribution of the national income in such a way as to cause a minimum of impairment of the existing pattern of the social structure—the so-called national culture or "way of life"—the preservation of which is the presumable objective of the military effort. In its operating measures, it should provide for its inevitable termination at the unknown future date which will mark the restoration of peace. Stating these same ideas in simpler but less explicit terms, the function of war finance is to distribute the national income in such a way as to provide for the requisite military effort, to distribute equitably the pecuniary sacri-

fices required by this effort, and to forestall the development of vested interests in the indefinite perpetuation of the war society.

It is currently realized that the functions and scope of war finance are much broader and more involved than they were supposed to be at the time of the first World War. At that time, the function of war finance was still considered to be the task of providing the Treasury with funds "to pay for the war." In that war, the method of war finance was to suspend the gold standard, assimilate the currency system with the public debt, and finance the war by "inflation." This left the price system intact, and it was only as the nations saw the consequences of their retention of the price system as a method of distributing a national money income multiplied by inflation, that they introduced partial and belated modifications under the name of controls. Essentially, every belligerent throughout the entire first World War relied upon the price system to effect the reallocation of the national income between military use and civil consumption, with the consequences we all know—inequality of sacrifice, war paupers and war profiteers, structural disorders from which some nations never recovered and which no nation wholly avoided, and in every instance a catastrophic transition from the war price system to the peace price system.

In the interval between the wars, the subject of war finance was generally neglected by theoretical writers; but in all countries a strong popular tradition remained. This tradition insisted on two elemental points—hostility to price inflation and hostility to the profiteer. These two elemental hostilities, which developed late in the last war, are the bases of contemporary theory of war finance; they furnish the theoretical continuity with the first World War,

and they provide a degree of validity for the often repeated statement that in the current war the principles and methods of war finance begin where they left off in the first World War.

These two hostilities, then, provide us with one premise of contemporary war finance—namely, a denial of the validity of the price system as the determinant for the distribution of the national income in the presence of a major war effort. This premise can be observed most strongly in the war finance of Germany, for in Germany the tradition of the first World War is most vivid; in England somewhat less strongly—especially in the early months of the war—for in England the tradition is weaker. In the United States, it is distinct in academic statements, in the press, and in the utterances of public officials. Nevertheless, in considering our own position, it must always be borne in mind that the tradition of the last war is far weaker here than in Europe; that the twin hostilities born of that tradition, while present, are decidedly weaker than in Europe. While we applaud the expressions of academicians, publicists, and officials, as being admirable statements of the function and scope of contemporary war finance, two things remain to be seen: (1) whether our responsible agencies (public and private) have the capacity to translate into effective action principles which they have, so to speak, learned by hearsay or derived from their own cerebrations rather than out of bitter personal experience; and (2) whether the American public, which is, in economic and pecuniary matters, much less a community or commonwealth than a federation of tightly organized, mutually jealous, and politically powerful groups, will be willing to accept these principles. To paraphrase Sidney Smith, it is

truly remarkable with what equanimity and fortitude we can endure the sacrifices of our neighbors.

CONFLICT BETWEEN PRICE SYSTEM AND WAR EFFORT

Because the economy of both Europe and America is what is called a money economy, any scheme of war finance must operate within a certain monetary framework. Most of the wars of the nineteenth century were fought within the framework of the gold standard. This limited, by mutual agreement so to speak, the duration, the magnitude, and even the ferocity of warfare. In the World War, the limitations of the gold standard were abandoned, enormously extending the military potential of the State, which, however, remained subject to the inhibitions of the price system. Theoretically in this present war, the military potential of no State is circumscribed either by the gold standard or the price system. Its only theoretical boundary is the physical productivity of the area under its control. But, although war finance concerns itself with the distribution of the national income—expressed in our case in dollars, since it is dollars that are paid in taxes and dollars that are lent on bonds—the national output which is to be distributed between the military program of the State and the consumption of the civil population is a physical income, an income of goods and services.

This physical income has definite limits. These limits occur in a variety of forms—in the supply of raw materials, in the existence of plant and equipment for processing these materials, and above all, in the supply of labor skilled in producing the specific products needed. None of these limits is absolute, but once the limiting zone is reached, it can be passed only at an increasing cost of time and money, and then with only uncertain results. As these

limits are approached, the problem of redistributing the potential of material, labor, and equipment broadens, and with it the scope of war finance, which may be amplified by all sorts of nonfinancial controls designed to the same end.

War finance may pass through three successive characteristic phases: the phase in which it is concerned with distributing an increasing national output; the phase in which it is concerned with distributing a national output incapable of further total expansion; and a final phase in which it is concerned with distributing a national output which is itself shrinking, or specifically, in which the fraction available to the public has become definitely shrunken. To use the familiar cliché, the first is the phase of more guns and more butter; the second, the phase of more guns and enough butter; the third, of more guns and a pat of oleo when you can get it.

In the peace economy, the relation between the national money income and the national output is maintained by the price system. The national product is produced at a money cost, which is recouped by its sale in a market, and one producer's cost is another producer's income. In the war economy, a large part of the national output is not produced for resale in a market. It is produced under a price system, but once produced it leaves the price system and never re-enters it. To take a simple example, under the peace economy, a motor truck is produced at a money cost, and sold for a money price to a user who in turn must recoup that price by selling the use of the truck for the transportation of goods. Under the war economy, a motor truck is produced at a money cost but it is not sold for a money price—it is "issued" to the service company of a regiment; it is then used for the transportation of goods, but no

money price is charged for that service, nor is any element of its original cost ever recouped by a charge for its subsequent use. It has passed out of the price system.

Under the peace economy, only a minor fraction of the national output lies outside the price system. For example, the services of a policeman are not charged directly to the recipient of those services, nor are they ever calculated by direct reference to the policeman's salary. Under the war economy a major fraction of the national output necessarily lies outside the price system; and the price system must be "loaded" to carry the part outside. Up to a point, the price system can carry this overcharge; beyond that point, it cannot. The price system no longer suffices as the distributor of the national output, and the State itself becomes the distributor of the national output, and the determinant of the distribution of the national money income.

This process has been exemplified over a good many years by the so-called totalitarian economies, which were essentially war economies long before the war; and the direct control of the distribution of the national money income in Russia and Germany is more derivative from the principles of war finance than from the economic doctrines of Communism in one, or of National Socialism in the other. No one would undertake to state the precise point at which the war economy can no longer be contained within the frame of the price system. No doubt it varies between countries. But we can state that such a point exists in any country and that when that point is reached, it will be empirically manifest. The inherent conflict between the price system and the war effort will either perceptibly impair the war effort, or the war effort will make existence so intolerable for those parts of the community still under

the price system that they will insist upon its abandonment.

MECHANISMS OF WAR FINANCE

The mechanisms of war finance are three—taxation, borrowing, and inflation. The first two are directed toward redistributing money income. That is, part of a money income received in payment for goods produced or services rendered is withheld from the satisfaction of the recipient's own wants, and is turned over to the Treasury in the form of taxes or loans. The recipient thus foregoes his claim to a share of the national income, and the State is able to claim a correspondingly larger share. Under inflation, the State increases the money income by creating money, and so is able to exercise a claim on the physical output without the necessity of any recipient of income surrendering any of his claims.

The simplicity of this enumeration of devices conceals the difficulties of their utilization. For the most part, they must be utilized by existing agencies of government, which are bound by experience and tradition, and which have become habituated to certain norms and forms of procedure inherited from the past. Second, they require for their effectiveness the closest coordination between the several agencies. In time of stress, there is a temptation to use "control" as a substitute for or equivalent of coordination, with a resultant loss of competent and experienced initiative; and anyone familiar with the hierarchical structure of government will appreciate that control is easier than coordination. In short, war finance is far more than fiscal policy; indeed, it is far more than fiscal policy amplified by a set of controls. Its function may be no less than the distribution of the national output at the discretion of,

and by, the volitional act of the State, through a corresponding and proportional distribution of the national money income. The scope is as wide as the national income itself. While its mechanisms are the familiar ones of taxation, borrowing, and credit creation, the ends to which these are evoked—the limitation or reduction of the standards of living—are so different from those usually associated with the ends of organized society, that they must be regarded from a new viewpoint and tested against unfamiliar criteria, under which most of the usual canons of public policy are invalid, irrelevant, or actually inverted.

OUR WAR FINANCE EXPERIENCE

The American effort of war finance is illustrative of the principles involved, although it can hardly be taken as typical. In spite of the extended period of war anticipation in Europe, the actual outbreak of war took the nations rather by surprise, as the long months of the “phony war” indicate. In this country, we have moved gradually, by a succession of phases, from neutrality to non-belligerency and on into undeclared warfare. The record unrolls like a slow-motion film, and so permits closer analysis than would be possible had the sequence been more rapid. On the other hand, one might say that the film had not rolled far enough fairly to disclose the plot of the story or the relation of the actors to it.

Our war finance experience may be explicitly dated from the beginning of the 1941 fiscal year (technically speaking), or from the invasion of western Europe (historically speaking). The program was launched by the President's speech of May 16, 1940; it was initiated with unusual dispatch. It was not, however, presented as a fully shaped design, but rather as a succession of designs, a fact that

must be taken into account in considering the measures of war finance, which in turn reflect a sequence of actions.

The measure of our armament program (as it concerns war finance) is not to be found in the appropriations, but in the actual expenditures. The fiscal year is not the time-space best calculated to illustrate the successive phases. But it is useful—first, because the initiation of the program happens to coincide with the beginning of the fiscal year; second, because the program to date has run only a little beyond one fiscal year; and finally, for pure statistical convenience.

In the fiscal year 1940, defense expenditures amounted to about one and one half billion dollars; in the fiscal year 1941, they were six billions, or four times as great. In the fiscal year 1940, they constituted about one-sixth of the total federal expenditure of nine billion dollars; in the fiscal year 1941, about one-half of the total federal expenditures of just under thirteen billions. In short, they passed from a minor element to the dominant element of federal expenditures. In the first four months of the current fiscal year, defense expenditures had risen to five billion dollars—almost as much as in the whole fiscal year of 1941. In this period, they constituted five-sevenths of the total expenditure, which illustrates the rate of progression with which the war finance program must keep pace one way or another.

For purposes of description, it is helpful to describe a progression of this sort in terms of phases; and a variety of reasons suggest that the fiscal year 1941 may be considered as a first phase, as long as no one imagines that a bracket of this sort has any definite boundaries.

As was said above, the finance program of this phase ran to almost thirteen billion dollars. Substantially, it was

financed to the extent of two-thirds by taxation, and one-third by borrowing. Of the amount borrowed, about one-half represented savings, and the other half bank credit created *ad hoc*. That is, about five-sixths of the expenditures represented a diversion of the money income, whether taken in the form of taxes or loans. Of the increment of federal expenditures (from nine billion to thirteen billion dollars) about half came from increased taxes.

The principal increase in taxation occurred in the form of the excess profits tax on corporations, in the inclusion among federal taxpayers of state and local functionaries hitherto exempt, in a minor lowering of the exemptions, and in the special defense surtax. As far as individuals were concerned, the only ones seriously affected were the comparatively small group of well-paid local officials; and the only two tax innovations that can properly be classed as distinctive war finance measures were the excess profits tax and the 10 per cent defense surtax.

CONTROL OF THE INCREASED NATIONAL MONEY INCOME

Meanwhile, under the stimulus of the armament program, the economy had evolved from a condition of semi-depression in the first half of 1940 to a condition of extreme activity by the second quarter of 1941. The index of production, which had averaged 115 for the first half of 1940, averaged 153 for the second quarter of 1941. Even more striking, the index of factory payrolls, which had been under 100 in the first half of 1940, was over 150 by June, 1941. With this activity, and after allowing for the ceiling on profits imposed by the excess profits tax, corporate earnings and dividends had risen. In short, incomes had risen more than taxes, and individuals after they had paid their taxes had a larger spendable income than before, with the result

that a boom demand for all sorts of consumer goods was added to the armament demand.

This fiscal year of 1941 represented the more guns *and* more butter phase of the war economy. There was a general increase in the national physical output and a general increase in the national money income. With only a comparatively minor alteration of the tax system, the Treasury was able to cover out of taxation about two-thirds of an enlarged budget, a slightly bigger fraction than in the two preceding years. It took more from the public in taxes and savings, but the remainder left to the public was larger than in former years, and this remainder the public spent upon more goods for its own use. This is the phase often referred to as "taking up the slack"; and in this process it seems at least arguable that the rather liberal reliance upon inflation, in the form of the use of bank credit as an element of war finance, performed a service. In this period, the price system itself furnished, as in a peace economy, a satisfactory method of distributing the money income over the physical product.

Establishment of Priorities

It is, of course, impossible to mark on the calendar the precise date at which the slack was taken up. In some fields, it had been taken up by late winter; in others, it still exists. The tests are empirical rather than statistical or theoretical; and the first clear indications that combined military and civil demand exceeded supply were signalled by the establishment of priorities. Priorities themselves are not an element of war finance; but their creation, number, and severity are important indicia in the guidance of war finance. By early spring, the money income of the country (amplified by credit inflation) was beginning to

exceed the physical output of the country. The establishment of any priority had the effect, principally, not of reducing civil demand, but of diverting it to an alternative or a substitute in which a ceiling was presently reached, necessitating the establishment of another priority; and as would be expected, prices began to move upward along a wide front.

As early as the end of 1940, the Federal Reserve authorities had warned of the imminence of this development, but their warnings fell on deaf ears. It was pointed out that there were still idle men and idle resources, and that there was no need of imposing general restrictions while there was still slack to be taken up. No action was taken in that quarter for several months. This illustrates several features always likely to appear in policies of war finance. First, it is difficult to demonstrate the need of action until the need has become obvious, which usually means long after the need has been discerned by those in closest touch with the factors involved. Second, the opposition to action will commonly advance arguments of a statistical character—criteria valid or plausible enough under ordinary conditions, but superseded by less familiar indicia. In this episode, for example, unemployment data were less valid as indicia of the relation between supply and demand than other empirical evidences, which indicated that the slack (which undoubtedly still existed here and there) was a statistical rather than an economic phenomenon. The first empirical evidence was the lengthening list of priorities. The second was the fact of rising prices, indicating that supply could meet demand only by excluding the demand of the lower bidder. By the spring of 1941, the defense boom, which had been generated by the defense program, was getting in the way of the defense program.

Defense Bonds and Installment Control

The Treasury, therefore, modified its program of war finance. In May, 1941, it offered to the public the three series of defense bonds, as successors to the previous United States savings bonds. These were intended to serve a double purpose. By taking these bonds, the individual reduced his own alternative competitive consumption; and at the same time, the Treasury by borrowing savings reduced its dependence upon bank credit, i.e., upon the inflationary mechanism. A few months later, the Federal Reserve System announced its intent to introduce controls into the area of installment credit.

Both these measures, by two instrumentalities of the State, were in accord with the general principles of war finance. Their common objective was to reduce civil demand—in the case of the defense bonds, by withdrawing from civil demand a fraction of consumer income; in the case of installment control, by restraining the enlargement of civil demand by the superimposition of borrowing upon income. Although mild, they were proportionate to the second phase of the war economy.

Increased Federal Reserve Requirements

As the autumn advanced, two other measures were taken which were illustrative examples of war finance. In late September, the Federal Reserve announced that on November 1 reserve requirements would be raised by one-seventh to the maxima of its legal discretion. The object of this was to impose a general restraint upon the expansion of credit, that is, upon the augmentation of the money income by the creation of additional money. This was in line with the general principle that the money income of a

country occupied at full capacity cannot be increased faster than, or out of proportion to, the physical income without leading to price dislocations. The intent clearly was to deter civil demand from becoming so large as to bid up prices in competition with the military demand.

New Excise Taxes

Almost simultaneously, the Treasury moved in this same direction by the imposition of a new schedule of excise taxes. The net effect of an excise tax is, of course, to increase the cost to the consumer. In ordinary fiscal policy, the object of an excise tax is to bring revenue into the Treasury without limiting consumption. In short, the tax should be precisely what the traffic will bear, without reducing the traffic. But excise taxes commonly partake of the nature of sumptuary legislation, and are levied on articles not of general necessity. Hence they are often called luxury taxes, the presumption being that the taxed articles are bought principally by the rich. Under war finance, the use of the excise tax may be theoretically inverted. Its aptitude as a revenue raiser may be subordinated to its capacity to limit specific consumption; here, its function is that of a substitute for rationing or priorities. When such is its purpose it is, of course, levied on (1) articles whose civil consumption is competitive with the military demand, and (2) at rates beyond what the traffic will bear, i.e., rates which will inhibit but not prohibit civil demand.

In the actual excise legislation of this autumn, there is no very clear recognition of the function of excise taxes as an element of war finance. Some of the articles taxed are competitive with the defense effort, some are not; where they are competitive, the rates are hardly high enough to

affect demand. In general, their war finance function has been concentrated on revenue rather than on a combination of the function of raising revenue with the function of reallocating civil demand, or of shifting civil demand from competitive to noncompetitive areas. In short, it would appear that this autumn's excise taxes were regarded more as luxury taxes imposed during a boom than as an integrated element of war finance. To the extent that this is true, they illustrate the dead hand of a tradition which insists that a particular fiscal mechanism, appropriately following certain canons in a peacetime economy, can with equal appropriateness follow the same canons in a scheme of war finance. Even more clearly they illustrate the manner in which clichés, catchwords, and slogans—the accumulated folklore of finance and fiscal policy—are retained under conditions which deprive them of all meaning. For example, the well-known dogma that high taxation will prevent inflation conceals the fact that under current conditions, certain kinds and magnitudes of taxes become active engines of inflation.

PRESENT PROBLEMS OF NATIONAL OUTPUT

At the present time, we are rather distinctly in the secondary phase of war economy—the phase of more guns and enough butter. We have expanded aggregate output to a point that can meet a military demand and a civil demand both greater than a year ago; it can meet a military demand greater than six months ago and a civil demand approximately equal to the supply of six months ago, but enough in excess of current supply to cause persistent pressure on prices. The spendable money income of civil consumers seems to be greater than the portion of the national output available for civil use. While some effort has been

made to reduce spendable civil income, it is clear that it has not yet been reduced to the level of available supply; and there are strong reasons to believe that the projected extension of military demand can only be realized by reducing civil supply below its present level. That is, we may not be far from the third phase of the war economy, in which we can expect more guns only if we have less butter—butter in this case meaning almost anything but butter in the whole varied range of goods desired by a civil population with money in its pockets.

Under the operations of the price system, competitive demand would rather readily adjust itself to supply, after a fashion. The goods desired would rise in price; those who had the price would get the goods, and the others would go without. Thus demand would be nicely fitted to supply. This would repeat the history of the first World War finance, but it would violate the accepted dogma of contemporary war finance which postulates equality of sacrifice.

At this point we encounter a problem of war finance that is extremely difficult, namely, the whole range of pecuniary phenomena that occur in the presence of a seller's market. It was quite easy to talk glibly about taking the profit out of war as long as the profiteer could be identified with a small group known as "merchants of death." It is not very easy to take the profit out of war when the beneficiaries of the war-induced seller's market are numerous large groups, who, finding themselves in a seller's market, see no reason why they should not turn their patriotic efforts to practical account. It becomes even more difficult when these groups are not actually conscious of making a profit out of war, but are merely maintaining what they have in ordinary times come to regard as a minimum right—namely, the re-

tention of a previous economic status. One can hardly marvel that the farmer does not see in this seller's market any reason to abandon his claim on price parity. Nor can one marvel that the urban workman should see no more than the barest justice in his demand that his wages should keep up with the cost of living. Nor, for that matter, does it seem like profiteering for the corporation executive to feel that it would be only fair if his salary were raised by such an amount as would leave his spendable income, after new taxes, equal to what it was before. None of these would be a conscious profiteer; indeed, all would unite in condemning profiteering.

Yet nothing can be clearer than the evidence that it is futile to try to limit consumption by taxes, defense bonds, or forced savings, if individual incomes are to be continually adjusted to the concept of parity, whether this parity is the familiar parity of agricultural discussion, or the "cost-of-living" parity of urban discussion. These concepts are traditional affirmations of the validity of the price system in a scheme of war finance whose very postulate and premise is a denial of the applicability of the price system as a determinant of the distribution of the national output.

It is, therefore, not at all surprising that we should encounter in our scheme of war finance, as it has developed to date, a good deal of contradiction. It is not surprising that Congress should successively approve the extension of the income tax to the low brackets for the specific purpose of limiting their consumption, and refuse to legislate for a wage ceiling. It is not surprising that Congress should still imagine that excise taxes are luxury taxes, rather than a device for channeling consumer expenditure out of competitive into noncompetitive areas. It is not surprising that Congress should have great faith in excess profits taxes as

restraints upon corporate profiteering, without recognizing that in a seller's market corporation taxes are readily shifted to the consumer—the largest single consumer (the price-making consumer) in this case being the government itself. These contradictions arise from the fact that all our fiscal traditions have evolved under the price system, and that contemporary war finance begins with a denial that the price system is applicable to a war economy.

If our defense effort is to be limited to the mere employment of the national surplus, these contradictions, while they would cause some degree of hardship, would not, of course, impair the military effort. But there is no positive evidence to support the theory that the war is to be so brief, or our military effort so small as this implies. The drift of events, the declarations of officials, the magnitude of the unexpended appropriations, all envisage efforts on a larger scale than those now in being. In short, contradictions in our war finance which would be unfortunate but not disastrous, if the military effort were to be small, cannot be so lightly dismissed. When we read the recent headlines that Congress has voted three to one against "price fixing" and in favor of "selective controls," the headline writer has stated an alternative that has no relevance to reality. He has assumed that the military effort is now and will continue to be so small that the functions of war finance can be contained within the boundary of the price system, as the war finance of the nineteenth century was usually contained within the boundary of the international gold standard.

Probably no economist would advocate the abandonment of the price system as a good in itself. Indeed, we are loath to confess the extent to which we have already abandoned the price system. We have seen two great nations

abandon the price system even before actual war began, because their general philosophy contemplated a perpetual war economy. We have seen England abandon the price system reluctantly under the pressure of war itself; not because this was good in itself, but because the war effort had attained such a magnitude that the functions of war finance could not be contained within that framework—that is, only after England realized that the magnitude of the war effort had itself determined the scope of war finance, and had foreclosed the alternatives.

It would be a grave matter for this country to abandon the price system. The alternative to the price system—the direct administration of the national income by the State—is far more difficult here than in a small island with a homogeneous population welded by history, tradition, and economic interest into a close-knit integrated community. But war finance is not an isolated entity; it is itself a function of the war economy, and this in turn is a function of foreign policy and of the military effort representing that policy. These determine the scope of war finance, and leave open merely a limited number of technological options.

CONCLUSION

To sum up, the function of war finance is not merely to provide money for war purposes. Under a system of irredeemable currency, nothing is easier than that. Its function is to provide funds for war purposes while at the same time maintaining and perpetuating that aggregate of institutions, which we call the national culture or way of life, for whose preservation the war effort itself is undertaken. Its third and equal function is to conduct its operations so

as to facilitate its own termination and to anticipate the inevitable, eventual transition from war to peace.

Its potential scope is as wide as the national income itself, but its operations within that scope are determined by the magnitude of the war effort. As long as the military demand is so small as to require no more than what may be called the surplus of the national income, the scope of war finance may be bounded, as it often was in the nineteenth century, by the confines of the international gold standard. If the war effort is of greater magnitude, it may require that war finance transcend the limits of the price system. The price system was retained by all nations in the first World War in its early phase, but the magnitude and duration of that contest proved too great to be contained within this frame. In the later phases of that struggle, war finance was a hybrid, neither acknowledging the price system itself nor a clear-cut alternative. It neither distributed equitably the sacrifices of war, nor anticipated the transition to peace, nor, for many of the belligerents, perpetuated the culture and way of life for whose maintenance or creation they had respectively fought.

In the current war, the principal belligerents abandoned the price system as promptly as they had abandoned the gold standard a generation earlier, and instead of permitting the price system to distribute the national income over the national output, charged the State, through its scheme of war finance, directly with the distribution of the national income and the allocation of the national output. That this increased the war potential seems indubitable; that it effected a more equitable distribution of sacrifice seems demonstrable; that it will perpetuate the national cultures or ways of life for which the several belligerents are fighting is, of course, still a matter of respective faith; and

whether it will eventually smooth the transition from war to peace remains to be seen.

In this country the war finance record to date is radically different. Our military effort, so far, has not been great; and our military program was launched in a generally semi-depressed economy. The initial phase, therefore, was concerned with the utilizing for military purposes of a surplus latent in the national potential. It did not need to concern itself with equalization of sacrifice because no sacrifice was asked of any. As long as the military demand kept within the limits of the national surplus, or putting it very crudely, as long as production increased faster than prices, it could be considered that the scope of war finance still lay within the capacity of the price system.

At this present point, a narrative description of the function and scope of American war financing properly stops. Our economy has completed its first phase—the exploitation of the potential surplus—and our methods of war finance have performed their function without causing manifest inequity of sacrifice, or without manifestly threatening the continuity of the American culture or way of life. Our effort to date has been no larger than could be contained within the boundaries of the price system; for the few controls we have introduced into our price structure in the name of war finance do not constitute of themselves an impairment of that system. It is, I think, easily demonstrable that our schemes of war finance are full of contradictions; but it would, I think, be impossible to demonstrate that these contradictions have as yet constituted any particular impediment to our military effort. It is obvious that this phase has ended. This is emphasized by the speeches of officials, our own reading of the pub-

lished statistics, and our own personal observations in daily life.

In the present and prospective phase of war economy, we may suppose that while the function of war finance will not change, the operations, the methods, and the techniques applicable to these functions will change, and that the scope of action will widen. With these changes, the contradictions in legislative and administrative procedure, the conflicts of official jurisdiction, and the clash of special interests will, of course, become more acute. The vested interests of its peace economy are already beginning to give way to the vested interests of the war economy. Tradition, precedent, and routine will lay a heavier hand upon innovation; and innovation in its turn will lay a heavy hand upon those traditions, precedents, and routines which in the aggregate make up the culture or way of life in whose defense we are undertaking this effort.

We must not expect that the realities of war finance will exactly approach the theoretical. No scheme of war finance can take the profit out of war or equalize the sacrifices of war. No scheme of war finance can preserve the continuity of culture or the way of life that would have developed had there been no war. No scheme of war finance can prevent the eventual transition from war economy to peace economy from being difficult and painful. But well-reasoned schemes of war finance can prevent flagrant profiteering; they can avoid wanton, careless, or subversive destruction within the way of life; and they can mitigate the hardships of the postwar period.

CHAPTER II

IMPLICATIONS OF FEDERAL FISCAL POLICY

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THERE SEEM to me to be four chief implications of the fiscal policy which we follow during this military effort:

First, our fiscal policy will be a prime factor determining what kind of economic system we will have in the postwar period.

Second, if we decide to follow a fiscal policy which will be conducive to retaining a free enterprise economic system, there must be enormously heavy taxes paid by the middle-class and the fixed income groups, not only after but before total civilian production declines.

Third, a fiscal policy which will permit retention of free enterprise will incidentally limit the increase in the public debt.

Fourth, if we retain the private enterprise system and keep the public debt within reasonable bounds, we will be able to face the problems of postwar economic adjustment with considerable confidence.

In order to establish these implications we need to consider briefly the imminent magnitude of government expenditures and the chief possible fiscal policies.

MAGNITUDE OF THE CURRENT FISCAL PROBLEM

As a base, let us take the fiscal year ending June 30, 1940, in which the federal government spent nine billion dollars. Under the impact of defense outlays, federal expenditures rose to nearly thirteen billions in fiscal 1941, and will probably approach thirty billions in the current fiscal year. In fiscal 1943, or fiscal 1944, it is not unreasonable to expect them to achieve a rate of fifty billion dollars. If national income by this time has reached one hundred billion dollars, roughly half will have to be taken by the federal government.

Whether or not federal expenditures in fiscal 1943 actually do amount to half of the national income, this estimate will surely prove realistic sometime during the prolonged military effort which now appears probable. If and when we commence in fact, as well as in words, to engage in an "all-out" military effort, we should at least be able to match the proportion of income now devoted to such purposes by the belligerents. England and Germany are now devoting more than half of their income to military ends quite aside from other government expenditures. Since these countries are poorer than ours, since their per capita real income in peacetime is far below our per capita real income, we can devote a greater proportion of our production to military ends than they, and still retain the minimum essentials of civilian life. Accordingly, in its minimum dimensions, the task confronting the fiscal authorities is to devise a program which will cause half the income of the country, or some fifty billion dollars at present prices, to flow through the federal treasury.

POSSIBLE REDUCTIONS IN NONDEFENSE EXPENDITURES

Confronted with such a rapid acceleration of defense expenditures, we may reasonably expect that nonmilitary expenditures of both federal and local governments shall decline. Many voices have recently urged such action—especially reduction of federal expenditures on nondefense activities—and considerable heat has been generated in discussions of this question. While I am convinced that a very substantial cut in nonmilitary expenditures is appropriate, such a policy should be considered in its proper perspective. In comparison with the necessary expansion of military expenditures, the possible cuts in nondefense outlays are of a rather small order of magnitude. Even if federal nondefense expenditures were reduced by as much as three billion dollars, for example, such a drastic reduction would not materially decrease the dimensions of the immediate fiscal problem. It would, therefore, be very foolish, if not disastrous, for us to consider reduction in nondefense expenditures as an alternative to a proper fiscal policy. Similarly, those who assert that we should first reduce nondefense expenditures, and then commence to consider the revenue problem, are surely misguided. These steps need to be taken simultaneously.

Without detailed consideration of the particular nondefense expenditures, we may nevertheless indicate certain basic principles which should govern the reductions proposed. First, government expenditures arising from the absence of full employment (in other words, expenditures designed primarily to promote employment or to provide relief for the unemployed) should be abandoned. Second, government investment which does not contribute to the war effort (e.g., the building of post offices or nondefense

highways) should be curtailed for the same reasons that private investment should be curtailed. Third, public civilian consumption (e.g., provision of recreation) must be reduced in the same manner that private civilian consumption is reduced.

METHODS OF FINANCING THE DEFENSE EFFORT

Broadly speaking, there are three ways in which the government can gain control of the purchasing power it needs to finance its military endeavor. First, it can levy taxes sufficiently high to obtain all the funds needed, except for the amount which can be raised by non-inflationary borrowing. Second, it can borrow either newly created or hitherto idle bank deposits, or it can turn to the printing press. This method can end only in inflation. Finally, if the government is determined to avoid a sharp rise in the level of prices, and yet cannot face the necessary increase in the tax burden, it can resort to price fixing and rationing, borrowing the public's unspent funds to purchase the goods and services which it requires.

The actual fiscal policy which this country will pursue will in all likelihood embody at least a partial application of all three of these devices. A clear understanding of their nature, however, requires that they be discussed separately.

TAXATION AND NON-INFLATIONARY BORROWING

If it is desired to keep the price level fairly stable and to avoid general price fixing and rationing, the simple answer to the problem of raising the purchasing power required by the government would seem to be to tax it away from the public. The public, having less to spend, would buy correspondingly less; the government, having more to spend, would buy correspondingly more. In large measure this

approach is correct as well as simple. There are certain impelling reasons, however, why some borrowing is desirable. First, there may be some savings which do not find an outlet in private investment. If these funds were hoarded, purchasing power would decline and unemployment or deflation would result. Second, if the defense effort starts from a point at which there are substantial amounts of unemployed resources in the country, it is clearly desirable that these resources be brought into use. To do this, the government should not limit its borrowings to uninvested savings alone, but should engage in income-expanding borrowing at the maximum rate consistent with maintenance of fairly stable prices. As the point of substantially full employment is approached, pump priming should be cut down until government borrowings equal, but no more than equal, uninvested savings.

Before going any further it may be worth while to make clear the exact sense in which I am using the terms, *savings* and *investment*, respectively, in this paper. *Savings* include the savings of both corporations and individuals. *Savings* of corporations are their undistributed earnings, after taxes, plus depreciation and depletion allowances. Individual *savings* are the difference between current income on the one hand and taxes plus consumption expenditures on the other. The term *investment* includes all expenditures incurred privately on plant, equipment, maintenance, increases in privately owned inventories, and the net "favorable" balance of trade with foreign countries.

In practice, it may be difficult to borrow an amount exactly equal to uninvested savings. Increased income will certainly tend to cause savings to rise at a rapid rate. Investment will likewise increase in the early stages of the military effort. When consumption becomes stabilized or

declines, however, and as the military demands upon the resources necessary for production of capital goods limit the possibilities of construction, investment will decline and, indeed, may almost entirely disappear. But while the increase in savings and the decline in investment will both tend to increase the possibilities of non-inflationary borrowing, another factor will constitute a counteracting influence. Since government expenditures must increase so rapidly and must bulk so large, there is no chance that uninvested savings can keep pace with expenditures. Therefore, taxes must be increased to supplement the borrowing of uninvested savings. But an increase of taxes, unless the most regressive tax system conceivable is adopted, will result in a decline in savings. As the rise in government expenditures outstrips the increase in national income and the decrease in investment, the amount of non-inflationary borrowing which the government can do will be reduced to very small proportions relative to total government expenditures. Since most savings come from the higher income groups, the more progressive the tax system, the less will be the volume of savings, and the smaller will be the amount the government will be able to borrow without inflationary consequences.

We thus see that if inflation is to be prevented without resort to price fixing and rationing, we must place our chief reliance upon the instrumentality of taxation. In the light of our discussion, it is clear how useless is some arbitrary ratio between borrowing and taxation, and how inaccurate the idea that the defense effort can, in large measure, be paid for by the savings arising from the increased national income associated with defense expenditures.

The essential problem of financing the war effort may be illustrated by the following highly simplified model. This

model assumes that the national income becomes stabilized, and that investment just equals depreciation and depletion allowances.

	<i>Calendar 1942</i>	<i>Calendar 1943</i>	<i>Calendar 1944</i>
National income	100	100	100
Federal expenditures	35	45	55
Federal taxes	20	35	50
Federal borrowing	15	10	5
Saving	15	10	5

Since saving is not increasing, borrowing cannot increase, and taxes must increase. Taxes will come partially out of savings, so borrowing must decline. Therefore, after a certain point, as federal expenditures increase, borrowing must decline not only relatively, but absolutely as well.

We may also apply this analysis in evaluating some of the methods frequently suggested for financing the defense effort without inflation. For example, there is a widespread notion that inflation can be prevented and higher taxes in some substantial measure forestalled, by having the government borrow directly from savers rather than from commercial banks. A related idea is that the form of the bonds employed in financing the government will significantly influence the effects of the fiscal program on the price level. It is frequently urged that the government should issue securities of such characteristics that banks could not, or would not, invest in them, so that no additional bank deposits would be created to swell the volume of circulating medium.

These ideas are in error. Borrowing by the government which exceeds uninvested savings, except in so far as total production can expand, must be inflationary. Borrowing which does not exceed uninvested savings is not inflation-

ary, no matter what the apparent source of the funds. This is true regardless of who the individual or institution buying the government bond may be. A defense savings bond paid for by reducing someone's cash balance at a bank may be just as inflationary as the sale of a bond to the bank itself. Only to the extent that the form of the obligations issued actually induces more savings or discourages investment, can it exert any influence in preventing inflation. It is difficult to believe that any campaign to sell savings bonds to small investors, or to encourage insurance companies to buy more government bonds, can substantially reduce either consumption of goods and services or private investments.

INFLATION

The military effort can conceivably be financed in whole, or in part, by borrowing or creating new money in excess of uninvested savings, and beyond possibilities of production expansion. By using this newly created purchasing power, the government can acquire the goods and services which it needs. Since a corresponding purchasing power will not have been taken from the public, and since production cannot expand by an equal amount, the total purchasing power in the market will exceed the supply of goods at erstwhile prices, and prices will rise. As long as this system is used, and to the extent to which it is used, the price level must continue to increase.

In addition to classic objections to inflation, there are three particular reasons why it is not a satisfactory device at the present. First, in order for the system to be used with reasonable success, the increases in prices must result primarily in increased incomes which will not be spent and, consequently, in an increase in uninvested savings. In so

far as increased disbursements find their way into the hands of persons who will spend them, this method of financing will result in a very rapid and probably intolerable rise in prices. Inflationary financing has worked in past wars because it resulted in high profits which were paid as taxes or which increased uninvested savings. Thus the inflationary process was kept within reasonable bounds. On the other hand, during the present military effort, a large portion of the disbursements of new credit in all probability will find its way into the hands of those who will spend it. Adjustments of rates of remuneration to increases in the cost-of-living index have become accepted as an essential part of the prevailing concept of social justice.

A second factor, which makes the inflation device a more vulnerable financing method than in the past, is the great volume of additional funds now in existence. If there is any substantial increase in prices, and the public anticipates still further rises, a great dishoarding may occur which will give an intolerable impetus to the price movement.

Thirdly, the inflationary device is feasible only when the job that is to be done is not too big. The current effort is so stupendous that primary reliance cannot be placed upon this time-honored device.

PRICE FIXING AND RATIONING

If we are unwilling to impose sufficiently heavy taxes, or to bid goods and services away from the public by the use of newly created money, we must finance the military effort in a third way. By the rationing of goods, we can limit the total amount of money which the public can spend. Then the government can borrow, either from the public itself, or from the banks, the equivalent of the unspent portion of the public's income.

It is probably safe to say that governments stumble into this means of financing themselves rather than adopt it consciously. The first step in the process is the fixing of maximum prices in an attempt to hold down the cost of living. The vast majority of the public, and even most politicians, probably believe that this is all that is necessary in order to solve the price problem; but they are soon disillusioned. At the prices fixed, demand for goods exceeds their supply. This is not at all surprising, for otherwise there would be no occasion for setting an upper limit to prices. With the amount demanded exceeding the amount supplied, and the automatic price mechanism for equalizing them suspended, someone must decide how much each of the would-be buyers may obtain. In the absence of other arrangements, this duty or prerogative naturally falls on the seller of the goods. Such a procedure quickly results in corruption, favoritism, discrimination—in short, in a condition of chaos in the distribution system.

Under these circumstances, the government is compelled to take to itself the responsibility of apportioning the available supply of goods—i.e., rationing. When the system of price fixing and rationing becomes widespread throughout the economy, people find that they are forced to save part of their income, either in the form of cash or of government bonds, because there is no way of spending it. The government can then borrow on a much larger scale without bringing about an increase of prices. If the rationing system is so administered that the amount the public will take of all commodities is no greater than the government is prepared to let them have, then the government can borrow one hundred per cent of its needs without fear of inflation, and a new method of financing the government is evolved. Thus we see that by indirection and without con-

scious realization of what is happening, governments stumble upon a third system of financing. With inadequate taxes, prices rise; this leads to price fixing, which in turn entails rationing; with an adequate rationing system, the government can finance itself through borrowing without inflationary consequences.

The general characteristics of a regime of price fixing and rationing are insufficiently recognized. Rationing is the distribution of the resources and economic products of a nation through some method other than prices. It is a planned economic system. The quantities and types of goods produced are determined by the judgment of government officials. The consumer is no longer free to use his money to buy what he wants at the ruling prices, but someone decides for him which articles, and how much of each, he may buy.¹ Instead of the present system of consumer choice and free enterprise, the economic system is operated by those who determine the prices and the rations. This means that the government, in effect, operates the economic system.

In judging whether or not we wish to adopt such a system in this time of emergency, the following seven factors should be given consideration: First, the administration of such a system will be one of immense difficulty. We have no assurance that the government will be able to create a bureaucracy which can satisfactorily determine how much of each commodity shall be produced and how it shall be distributed. The enforcement of rations among millions of consumers, through hundreds of thousands of outlets and the determination of thousands of prices, is a stupendous

¹ For an admirable statement of the case for adequate compulsory transfer of purchasing power from the public to the government in preference to widespread dependence upon price fixing and rationing, see John Maynard Keynes, *How to Pay for the War*, Chap. VIII.

task. In European countries, rationing has necessitated the creation of a gigantic bureaucracy supplemented by a system of espionage. In spite of all this, enforcement is extremely difficult and evasion is rampant. In this country, with our vast expanse of territory, our large number of actually or potentially self-sufficient persons, and our disinclination to bow unquestioningly to authority, the difficulties would be immensely greater.

Second, each individual will be told exactly what he can consume. Third, persons in the middle and upper income groups will have no consumption advantage over those in lower income groups. Fourth, this completely equalitarian distribution system may greatly reduce the efficiency of the economic system by reducing incentives to work extra hours, or to work at more difficult tasks, or to move to tasks where there is greater need. If getting an increased income will not increase the amount which one may consume, there will be little pecuniary incentive for the individual to attempt to increase his income. Moreover, if there is no adequate pecuniary incentive for the individual to apply his services where they are most needed on a basis of what he is paid, then, fifth, the State will have to dictate to every individual where he shall work, and how much he shall work, thus achieving a system which might be termed State slavery. Sixth, a system of rationing would necessitate a much more powerful government than would a system of taxation adequate to prevent inflation and to carry the war burden. Seventh, an economic system not operated by the government is much more possible in the postwar era if we have not instituted a system of government operation during the war.

THE CHOICE

In carrying on the war effort, therefore, we have to choose between heavy taxes, inflation, or a system of rationing which implies essential abandonment of the private business system. The public need to recognize that this is the choice which is being made. They know that both taxation and inflation are disagreeable. They do not realize that if they refuse to accept either of them, they will inevitably find rationing forced upon them. They may not be much impressed by the abstract argument that rationing and price fixing involve suspension of the system of free enterprise, but they should be impressed with the effects of rationing on their daily lives. If they could be convinced that an all-out war effort involved, for example, either giving the government fifty per cent of their income while remaining free to spend the other fifty per cent as they pleased, or, on the other hand, having the government—through a gigantic and cumbersome bureaucracy—dole out to them an amount of goods in prescribed proportions equal to fifty per cent of their customary consumption, they might greatly prefer the former arrangement. If it is true that we must have either taxation or rationing, the public need to understand the essential characteristics and implications of both systems, and to choose between them on their merits, rather than blindly to accept the rationing system by default.

Unfortunately, the character of the approach to the problem common in many quarters indicates that the inevitability of this choice is not generally understood. It is sometimes urged that, whatever the level of taxes necessary to prevent inflation may be, increases to this level should be made gradually because of the extreme hardship involved.

Those who argue this way either are ignorant of, or refuse to face, the fact that in our present situation we have no escape from extreme hardship. If we refuse to pay the price of military security in the form of adequately high taxes, we must pay it in the form of a higher cost of living in relation to our income, or else in the form of reduced rations of the things of daily consumption. But pay we must, and the sooner everyone understands this, the sooner will it be possible to make an intelligent decision as to the least harmful and least disagreeable way of paying.

The future structure of our economic system depends very largely upon the fiscal policy which we follow during this military effort. Widespread opinion has long existed that fiscal policy is not merely a means of raising given revenues, but a primary device for monetary control, business-cycle control, and determination of the amount of the national income. Now we must recognize that fiscal policy, particularly at a time like the present when government expenditures bulk so large, is one of the keys to the nature of our future economic system. If we wish to preserve a private business system, we may be able to do so by means of taxes of the order of magnitude of government expenditures. If we keep taxes low, and adopt a system of price controls and rationing, we shall effectively promote government operation of the economic system. Those who object to financing the war through taxes cast their vote for an administered economy.

We may well ask why we should expect results to follow from this war effort which did not follow from the war effort of 1917-18. Though we did have an inflation, though we did control prices and ration goods, we did revert after the war to an economic system quite comparable to that which prevailed before.

Several brief points suggesting the answer to this question may be made. First, we know that many European countries which were more intensively involved in the first World War than we were never did achieve anything approximating their prewar economies. Second, our military effort during that war was of much shorter duration than it bids fair to be in this war. Third, a smaller proportion of our national income was devoted to military purposes than we very likely will devote in this effort. Fourth, we depended primarily upon the taxation and inflation devices, and took only a few tentative steps in the field of price fixing and rationing. In conclusion, we may say that if in this effort we do depend upon taxation and inflation to the same relative extent and make no more use of rationing than we did in the last war, then it is true that so far as this type of economic consideration is concerned, there is no more reason to suppose that we will have difficulty reverting to our prewar status than on the previous occasion.

THE POSITIVE CASE FOR RATIONING

While as a political reality rationing is adopted by default and not as a deliberate choice, a body of doctrine has developed supporting the system as the most desirable of possible procedures. Its defense rests on two bases—equity and productivity.

Nothing very conclusive can be said about the equity argument. There are always many intelligent and high-minded persons who think that an equalitarian system of economic distribution should be adopted. We are all acquainted with the very plausible arguments in support of a communist economic system, both on the distribution side and on the production side. To date we have voted to retain a non-equalitarian system. There are some of us who

believe that while a great deal may be done to limit inequality, retention of a substantial amount of inequality, giving rewards in some relation to productivity, is conducive to efficiency and to the greatest human welfare. These matters are not capable of conclusive proof. Certainly it is futile for me to say any more on the subject here.

If an equalitarian system is not desirable in peace, however, in my opinion, it is not desirable in war. I do believe that we can and should reduce inequalities during the war. The burden of the war should be borne largely by the higher income groups, not by the lower, and as the war burden increases, the costs should be met not by increasing the levies on the lower income groups, but by moving downward the line of demarcation between the high and the low. Thus we can, through progressive taxation, while still retaining a system of income differentials, keep the costs of the war off the poor. Indeed, if for no other reason, we should do so merely on the grounds that their incomes are now no more than is necessary to maintain efficiency.

Looked at from one standpoint, the rationing system is one of spurious equalitarianism. If a high progressive tax system were used to finance the war, the higher income classes would be able to increase their wealth very little during the war. If the rationing system is used, the high-income groups will increase their wealth during the war and have much greater economic claims in the postwar period. On the other hand, a highly progressive tax system may, in fact, result in about as close an approximation of equalitarianism as rationing. If the income after taxes of the \$5,000 man is \$2,500, and the income of the \$1,500 man is not touched, the former may have sufficient obligations in the way of house amortization, insurance premiums, etc.,

that he will be able to buy goods in the market at no greater rate than the \$1,500 man.

Let us now turn to the productivity argument for rationing. Those who argue for rationing on the basis of maximum productivity claim that to institute heavy taxation as soon as prices begin to rise is to restrict production unnecessarily. Price rises, they assert, are the result of bottlenecks; and when a large segment of the economy is given over to the production of military goods, bottlenecks are reached more rapidly than in peacetime when different types of resources are utilized at a more uniform rate. If an attempt is made to keep the price level from rising by the use of the over-all method of taxes, the result will be to cut off prematurely the increase in the national income, and to prevent the utilization of resources which are still unemployed. It follows, so the argument runs, that the military effort is prevented from attaining its maximum potential effectiveness. Instead of increasing taxes, they argue, the government should continue to borrow in excess of uninvested savings and, as successive bottlenecks arise, it should fix prices and ration in the affected areas.

This line of argument might be more plausible if the elements of the cost of living which are rising most were not precisely those fields, such as food and clothing, into which purchasing power, according to the theory, might be expected to flow, and in which production might be expected to expand without great price increases. Price control and rationing in this case could not have increased production by forcing purchasing power into fields operating below capacity, since the fields of the price rise are presumably the classic fields of overcapacity. The use of the fiscal device to prevent undue rises in the costs of living will not, in the main, limit the expansion in fields of unused capac-

ity, since the chief items in the cost of living, for example, food, clothing, etc., are precisely the fields in which are to be found most of whatever unused capacity does exist.

Finally, even if there were some evidence that further expansion of purchasing power coordinated with proper price fixing and rationing would increase production, it does not necessarily follow that such an increase in production would be desirable. We are primarily interested at the present time not in maximum production as such, but in maximum military effort. Unfortunately, expansion of civilian goods production in a wartime emergency inevitably involves some alternative military costs, that is, some sacrifice in military production. There is scarcely a single civilian goods industry which can be expanded without using resources in manpower or materials which otherwise could have made some contribution to the military effort. If price control and rationing will actually expand total production and employment, they will do so at the price of maximum military effort.

CHARACTERISTICS OF A TAX PROGRAM

Whether or not either inflation or rationing is employed in part to finance the defense program, substantial increases in taxation have been and will continue to be made. Accordingly, the problem of devising a tax system which will fairly allocate the burden of taxes, without imposing undue restraints upon output, will become progressively more important.

In this discussion, I propose to include as types of taxes both social security levies and forced loans. Like income and other taxes, both represent direct and straightforward methods of transferring purchasing power from the public to the government. As far as immediate effects are con-

cerned, it makes only a minor difference whether the public is given a tax receipt, a claim to benefits in the event of future contingencies, or a government bond. Variations in effect are no greater than variations between different types of taxes.

CRITERIA OF TAXATION FOR DEFENSE PURPOSES

In general, there is no reason why the characteristics of an equitable tax system in time of war should be different from that in time of peace. In either situation a progressive tax system is desirable. I believe that we should aim at substituting the graduated personal income tax for regressive levies in time of peace. Likewise, in the event of war or of other increased need for tax revenue, I believe we should also depend upon the graduated personal income tax for the bulk of additional revenues.

The type of tax structure we must have will depend, in large measure, on our decision as to what part of our total requirements is to be raised by taxes and what part by borrowing. Our choice lies between two extremes. We can choose the smallest amount of taxes, i.e., the largest amount of borrowing, consistent with stable prices. This implies a very regressive tax system. Or we can choose to borrow the smallest amount possible, i.e., tax the largest amount possible, consistent with stable prices and full employment. This would require a highly progressive tax system, as progressive as one could impose and still maintain adequate incentives.

It is the duty of public officials to present the choice between these two extremes to the public. I am inclined to believe that if the issues were properly submitted, they would choose the latter alternative, namely the high taxes, the low borrowing—the progressive tax system. Despite

the fact that there may not be unanimity of opinion on the proper choice between these two types of taxation, there is scarcely any segment of the population which ought not (in its own self-interest) to prefer either of them to the alternatives of inflation or rationing. For this reason, it is most regrettable that some groups oppose all proposed taxes which are not to their liking. By doing so, they are, in effect, opposing any taxation, and thus inviting either inflation or rationing.

ALLOCATION OF BURDEN AMONG INCOME GROUPS

If it be granted that it is desirable to finance the defense effort principally by taxes, and that a progressive system of taxation is the best, the real problem lies in deciding the degree of progression desirable.

The tax system prevailing in this country in the immediate past has not been a satisfactory example of progression. A TNEC study has shown that for levels of income below \$1,000, total tax payments, federal, state, and local, direct and indirect, have been definitely regressive; for levels of income between \$1,000 and \$10,000, tax payments have been roughly proportional to income. Only for income groups above \$10,000 has there been effective progression.²

If we are to finance an all-out war effort by taxation and the very modest amount of borrowing that will be possible without creating general price increases, it will be necessary to bear very much more heavily on the so-called middle-income groups. This is particularly true because of the present lack of progression in the tax system in this important area in the past. The Revenue Act of 1941 recognized

² G. Colm and H. Tarasov, *Who Pays the Taxes?* Monograph No. 3, Temporary National Economic Committee, p. 6.

this fact, but did not go far enough, either in providing sufficient additional revenue, or in stepping up the effective rates on the middle groups. If the war effort should require as much as half the national income, then taxes should amount to nearly half the national income. In this event, in view of the limited productivity of higher taxes on the upper income brackets, and in view of the necessity for exempting from taxation amounts necessary to maintain efficiency, the middle-income groups must certainly bear an over-all tax burden amounting to at least 50 per cent of their total income. For example, a man with \$4,000 in income probably should pay 50 per cent of this in taxes, and a man with \$10,000 income, 70 per cent.

The hardships involved in such a program are more apparent to the general public in advance, but, as we have already seen, they are less severe than the hardships involved in any other type of program which diverts an equally large share of the total national income to the defense effort. Opposition of the middle income and upper income groups to higher taxes, therefore, in my opinion, is misguided and shortsighted. If adequate taxes are not adopted, and inflation is prevented by widespread adoption of price control and rationing, the rations allotted to these groups will certainly restrict their consumption more narrowly than the highest conceivable taxes. In fact, this is considered by advocates of rationing to be one of its major virtues. More important, in the long run, by opposing adequate taxes, the middle and upper income groups will be helping to destroy the very kind of economic system of which they are the prime beneficiaries.

Not only should the middle income groups bear very much heavier tax burdens, if the defense effort is in any substantial measure to be financed by taxation, but those

of us whose incomes have increased little or not at all, in my opinion, must be subject to the same tax rates as those whose incomes have increased as a direct or indirect result of the defense program. We with fixed (or relatively fixed) incomes are inclined to think that only those whose incomes have benefited from the defense effort should be subject to taxation to pay for it. Many of us, I fear, cannot understand why we whose incomes are not increasing should be required to reduce our consumption, except when civilian production is declining, and then only in proportion to the total reduction in civilian consumption.

The answer is that to feed, clothe, and otherwise maintain the newly employed or more effectively employed producers, we must grant them consumption goods greater in amount than the increased production of such goods. We cannot expect the newly employed and the more effectively employed to produce all the military goods plus all their increased consumption. They may be able for a time to provide all of the military output and part of their consumption, but the rest of their consumption must come from a reduction of consumption on the part of those whose income status has not changed. It is a curious idea that the burden of the war should be borne by those who were badly off before the war, while those who were well off both before and during the war should be treated very gently. Finally, unless we propose to supplant the free enterprise system of incentives with a system of State slavery, persons must be allowed to retain a portion of the gains which they receive from accepting employment, working harder or longer, or changing jobs.

The idea of taxing in such a manner that no one would benefit from preparation for war is defensible only in terms of the widely circulated doctrine of earlier years, that it

was a method of avoiding preparation for war. But if it is now public policy to prepare for war, this reason for removing benefits from war has disappeared. Indeed, on the basis of incentive considerations, there is now reason for taxing the defense increments of income less intensively rather than more intensively. In so far as the benefit doctrine deserves any consideration in this connection, surely the man with a consistently higher income has more to gain from preserving our way of life than one who receives this income for the first time.

In the last war, the fallacy was prevalent that the burden of the war could be avoided by borrowing. In this war, the prevailing fallacy is that sacrifice can be avoided by taxing primarily those whose incomes benefit from the increase in total national production. The fact that the military effort in its initial steps has been accompanied by an increase in total national production, however, has little bearing on the extent of the sacrifices required of the fixed income groups. If we had started the defense program at a time of full employment, there would not have been much question of the inevitability of immediate sacrifices. Since we started with unemployment, there seems to have been a feeling that until full employment was reached, no one needed to make any sacrifices, and that, then, the sacrifices need be only to the extent of any decline in the production of civilian goods. Actually, it is necessary that the group whose employment status is not changed must bear nearly as great a burden from the beginning as though full employment had prevailed throughout the military effort. The increased production of the country must go largely to military ends. The increased consumption of those who have received additional or better paid employment must

come largely from reduction of consumption by the fixed income groups.

CONCLUSION

In summary I have tried to make the following points:

First, inadequate taxes will cause a great and possibly permanent revolution in our economic structure.

Second, it is to the selfish interest of the middle and fixed income groups to pay greatly increased taxes now before total production of civilian goods declines, and to pay even heavier taxes which will leave them little more than a mere subsistence when we achieve an all-out effort.

Third, the form in which government obligations are issued, the purchasers who acquire them, and whether or not such obligations are acquired by the banks, are of little significance.

PART TWO

EXCESS PROFITS TAXATION

CHAPTER III

INFLUENCE OF EXCESS PROFITS TAXATION ON BUSINESS POLICY

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BEFORE attempting to discuss specifically the influence of the excess profits tax on business policies, perhaps it would be desirable to examine briefly the basic structure of our present excess profits tax law and review its background.

STRUCTURE OF PRESENT LAW

Some twenty-four years ago, the United States invited an excess profits tax into the fiscal family to help win the war, and four years later it dismissed the newcomer with no kind word and many a harsh one. The cries that went up at that time seemed assurance that no similar invitation would be issued short of actual involvement in another war—and perhaps not then. Yet 1941 finds business and the public generally accepting an excess profits measure, not only with calmness, but, in some instances, with enthusiasm. I think that the manner in which the public has accepted these hugely increased taxes, especially those affecting the low-income groups, is but another indication that the “share the wealth” idea so prevalent a short time ago is now dead, and that the American people are anxious, instead, to share the cost of American defense.

We are all aware, I am sure, of the difficulties involved

in devising a sound, equitable, and practical excess profits tax program. For instance, before we can tax excess profits, we must resolve the very difficult problem of ascertaining what are "excess" profits. Are they profits in excess of what the company has been earning, or those in excess of a given rate? And if the latter, is the rate based upon a percentage of invested capital, or the value of the assets employed, or what? These terms, "invested capital," "normal profit," "excess profit," sound simple to define, but when the economists, lawyers, and accountants have finished with them, they become as elusive as the concepts of the higher theology.

In defining excess profits, the old excess profits taxes of 1917 and 1921 used invested capital as a base, and all income in excess of a stated return (seven to nine per cent in 1917 and eight per cent in 1918-21) on such capital was taxed at graduated rates. On the other hand, the old war profits tax adopted in 1918 used normal earnings as a criterion, and all profits made above this normal were taxed at a rate of eighty per cent. After much wrangling as to which of these methods should be adopted to determine normal income for our new excess profits tax program, Congress finally compromised by using both. In other words, a corporation now has a choice of the more favorable of the two ways of determining what profits are excess and what profits are normal. Thus, a profit, to be taxable for excess profits tax purposes, must be not only in excess of prescribed rates on invested capital (eight per cent on the first \$5,000,000 and seven per cent thereafter), but also in excess of the base period income.

It was also concluded that invested capital should include not only equity capital but borrowed capital as well. All of the equity capital, but only one-half of the borrowed

capital, however, was to be treated as invested capital. The equity capital is determined primarily by the amount of cash and property paid into the corporation for stock or surplus, plus accumulated earnings and profits. Appreciation or reduction in the value of the assets used in the business is not to be taken into consideration. As to borrowed capital, only debts in written form are to be included as invested capital.

In figuring the tax, a corporation that selects the normal earnings method must take its income experience of 1936 through 1939 as a criterion, and 95 per cent of the average profits of that period are treated as normal earnings. Under the so-called growth provisions of the law, corporations, whose earnings during the last two years of the period are larger than during the first two years, are entitled to certain increased exemptions. The profits on which this tax is calculated are altogether different from the profits for regular income tax purposes. One of the most important differences is that, in determining excess profits, gain or loss on the sale of property held over eighteen months is disregarded.

Dividends received by a corporation are not taxable at all for the excess profits tax. On the other hand, as one-half the borrowed capital is treated as invested capital by a corporation using that method, only one-half of the interest on this borrowed capital is allowed as a deduction for excess profits tax purposes, although all of it is allowed for income tax purposes.

The amount of the tax itself is determined by deducting from the excess profits net income the excess profits tax credit, whether on the invested capital or earnings basis, plus a specific exemption of \$5,000. The adjusted excess

profits net income thus arrived at is then taxed at rates graduating from 35 per cent to 60 per cent.

This, in barest outline, is the structure of our present excess profits tax program. While outlining it in this summary fashion may make it sound like a simple set-up, let me assure you that, instead, it is one of the most complicated pieces of tax legislation ever adopted by Congress. It is, indeed, as one commentator put it, "an imponderable mass." Depending upon one's point of view, this law is either a tax expert's nightmare or delight. In any event, one immediate effect that this program had on business was almost completely to cure the unemployment problem among lawyers and accountants. Some of its other effects, in terms of business practices that it has brought into being, would, I am sure, be quite a surprise to the writers of this law.

EFFECT ON DEFENSE PROGRAM

One of the most common observations as to the effect of the excess profits tax on business policy is that its adoption has resulted in retarding plant expansion and, therefore, seriously impeding the defense program. This contention is based upon the premise that the taxing of profits at the high rates prescribed dulls production incentive. Also that, because it largely confiscates profits, there are no funds left which might be used for expansion. While it is true that the excess profits tax rates are high, yet it appears that, so far at least, business in general has been able to absorb the tax. There is little indication that the tax has yet had any detrimental effect on plant expansion, at least in the cases of corporations whose activities are a matter of public record.

While this is true as to businesses now in existence, the

effect appears somewhat different as to new enterprises. Risk of failure is much greater for new enterprises than for established concerns. The promoter of a new enterprise must, therefore, be able to anticipate more than normal profits to warrant his taking a gamble with failure. As the tax law treats "abnormal" profit as "excess" profit and confiscates a large part of it, the chances are weighted against the embarking upon new enterprises. Accordingly, there can be little doubt but that the excess profits tax definitely retards new business expansion.

INFLUENCE ON PRICES

Directly related to this matter of profits and expansion is the effect of the excess profits tax on prices and price policy. In theory, an excess profits tax is not supposed to have any effect on prices. According to most economists, such a tax cannot be passed on. It is argued that a business that pays an excess profits tax and attempts to pass it on, usually finds itself in competition with less fortunate producers operating at a normal profit level who pay no such tax and, hence, are under no pressure to raise their prices.

While this reasoning may be sound during normal times, there can be little question that in a seller's market, such as we are now experiencing, the tax does influence prices. Sellers argue that they have a new tax item that must be included in their cost, and that they must increase their prices to cover the added cost. Since the demand for their product is insistent, they usually have little difficulty in passing the tax on. Thus, while this kind of economic reasoning may be condemned as fallacious, that does not prevent it from acting as a positive factor in forcing up prices and profits. By a curious inversion, therefore, a tax

that was designed to correct excess profits has become, itself, a cause for excess profits.

That this is so in actual practice can be readily confirmed by a mere glance at recent published reports of public corporations. From these it is abundantly clear that, in general, not only have corporations been able to absorb the excess profits tax, but, in many instances, profits have risen far beyond the added tax. Statistics show that increased prices were a substantial contributing factor in these increased profits. Thus, contrary to all theoretical argument from this angle, the excess profits tax has actually accentuated the inflationary tendency of prices rather than retarded it.

There are, in addition, two incidental and more or less conflicting factors bearing on the relationship of the excess profits tax to prices—one tending to push prices down, and the other to put them up. The factor which tends to put prices down operates on those who look to the future, and who feel, that because the government largely absorbs any reduction in prices through reduction in tax, there is an incentive to lowering them and thus building up goodwill with its customers. On the other hand, the factor that tends to put prices up is the lack of resistance to increased costs on the part of purchasers. With a tax rate as high as 75 per cent, some buyers raise little objection to higher prices because they feel that the government is paying the shot to a very large extent anyway.

EXTRAVAGANT EXPENDITURES

Another influence of the excess profits tax along this latter path is the encouragement that it gives to extravagant expenditures in general, and especially to those of a type that can now be deducted for tax purposes but which

promise an income in the future, when, perhaps, the excess profits tax has been repealed or has had its rates reduced. This phase has its effect only on the optimist, of course, since one must indeed be an optimist to foresee possible tax reduction in the future. In any event, there appear to be quite a few optimists around, for it is surprising to know the extent to which such expenditures are being indulged in. Goodwill advertising, for instance, has tremendously increased in recent months. A similar phenomenon will be recalled in the first World War days. At that time, trade and other magazines were booked for months ahead and it was very difficult to secure space in them. Those who indulged in this process in 1917-21 undoubtedly came out ahead of the game, for many of them realized increased profits out of such expenditures in later years when tax rates were considerably lower. Similarly, at the present time, many corporations are expanding their advertising, research, experimental, and developmental activities, improving their organizations and personnel, opening new and costly branches, and spending money by other devices which give an immediate tax deduction and promise a deferred income. One of the very popular expenditures in this connection is the payment of liberal bonuses and increased salaries to executives and employees. The net effect of all this is, in many instances, to promote gross inefficiency. Necessarily, management becomes careless, and control of expenditures becomes ineffective when the psychology is to spend as much as possible, in order to increase costs and reduce income.

EFFECTS ON BUSINESS PROCEDURE AND POLICY

The graduated tax rates under the present law are based upon absolute dollar amounts of excess profits, and not on

a relative basis, such as ratio of profits to capital or ratio of current to previous earnings. In other words, the greater the amount of the profits as such, the greater the rate of the tax. When the law was passed, this basis of graduation was vigorously condemned as an unwarranted attack on bigness. It was argued that a big company earning a narrow margin of profit on its volume or capital is, even though the aggregate amount of its profits be substantial, less able to bear taxation than a small company with a high rate of profit on its volume or capital; and, further, that the profit of the big company might belong to a large number of poor widows, while the profit of the little company might all go to a few rich people.

While I do not want to get into the details of this argument, I do want to indicate, in passing, that to my mind the rate structure on an amount basis may be justifiable. A big company with a million dollar profit has tremendously greater power than a little company with a ten thousand dollar profit and, therefore, the big company should pay extra taxes to support the government which is set up to protect that power. The poor widows who invest in a billion dollar corporation are partners in an enterprise of this proportionate power. Therefore, they should pay extra taxes because of the protection of that power.

In any event, whatever the merits of this method of graduating tax rates, it has had one outstanding business effect. Because it lessens the desirability of size, it has—whether for good or for evil—definitely acted as a damper on mergers and consolidations. Quite to the contrary, it has made advantageous a multiplicity of corporations in the form of subsidiaries, affiliates, etc. Obviously, with the tax rate being graduated on an amount basis, if large corporate incomes can be divided among a number of corpora-

tions, the aggregate tax is reduced, whereas, per contra, the tax goes up if two or more profitable corporations are merged. While the law attempts, in some of its provisions, to block the breaking up of large corporations into small ones for the purpose of securing tax advantage, you will nevertheless find, if you look closely enough, that, with this rate structure acting as fertilizer, two corporations can be made to grow where one grew before.

CONCRETE PROVISIONS OF PRESENT LAW

Now let us turn to a consideration of a few concrete provisions of the present excess profits tax law and their effects on business policy.

Earnings and Dividends

As I have indicated, under the law the invested capital of a corporation includes not only the amount paid in for its shares, but accumulated earnings as well. The natural effect of including accumulated earnings as part of the invested capital structure is to encourage the retention of earnings by corporations, and, conversely, to discourage dividend distributions to shareholders. Since, for corporations that adopt the invested capital method, the larger the invested capital the lower the tax, accumulations of profits obviously yield desirable tax results. The effect of this situation is to bring about almost exactly the opposite result than that which was sought to be accomplished through the adoption of the late lamented, undistributed profits tax. Instead of giving an incentive to distribute earnings, as the undistributed profits tax attempted to do, a potent incentive is now given toward accumulation of earnings. If this situation continues, it is not unlikely that corporations will build up large accumulations of idle

capital, and we may be back again to the good old days of 1929—when we had that grandest of all conditions, corporations all saving for a rainy day, and Mr. Hoover promising that “it ain’t gonna rain no more.”

An additional and incidental factor in connection with this matter of retention of earnings is the timing of dividend distributions. The present law contains a provision that makes dividends paid within the first sixty days of an accounting period a reduction of capital investment of the corporation for the year involved, whereas dividends paid after the sixty-day period do not diminish invested capital. Thus, there has been injected an arbitrary and artificial factor into the timing of dividend distributions, and during the last two years you may have noticed that boards of directors have suddenly taken quite a liking to the sixty-first day of the year.

Borrowed Capital

It has already been pointed out that the present law permits 50 per cent of borrowed capital to be included in invested capital, and allows the interest on the non-included debt as a deduction in arriving at excess profits income. Even before the excess profits tax was adopted, the fact that interest paid on borrowed capital was allowed as a deduction for income tax purposes, whereas dividends on preferred stock were not so allowed, gave an incentive to corporate financing through bonds rather than stock. Now, with tax rates shooting skyward and with the additional factor of borrowed capital being included in invested capital, this incentive has been considerably accelerated. Accordingly, many corporations that are in a position to do so are now replacing their preferred stocks with bonds. This situation has also unduly encouraged the flow of new

capital into corporations by way of debt rather than through permanent capital.

Not only does this inclusion of borrowed capital in invested capital, and the allowance of interest as a deduction give an incentive to debt financing as such, but many a capital structure is now being internally reconstructed so as to convert capital into debt. Under our income tax law, certain recapitalizations may be accomplished without subjecting the holder of securities in the corporation, or the corporation itself, to taxable gain. As a result, it is not at all unusual to find corporations recapitalizing their businesses by exchanging not only preferred stocks, but in some cases common stocks as well, for debt bearing securities, in order to secure the tax advantages.

It is difficult to understand why our tax laws have gone out of their way to give rewards to corporations that go into debt as distinguished from those that acquire capital contributions. This encouragement of debt inflation is certainly a process fraught with serious dangers, for it is sure to bring about many an unsound financial structure, and lay up troubles when the rainy day again inevitably appears.

There is another phase of this matter of debt in relation to the excess profits tax. Some corporations that use the invested capital method for excess profits tax purposes have found that it will yield them a profit to borrow money, even though they do not actually need the money so borrowed in the business. The prevailing interest rate for short-term borrowings is very low and, since an exemption of seven or eight per cent is secured on fifty per cent of such loans, it does not take an Einstein to figure out that a substantial tax saving can often be effected by such borrowings. While the Treasury has indicated that it will

not allow borrowed money in invested capital unless it is actually employed in the business, yet the difficulties of determining how much is so needed and employed make it probable that only the most obvious attempts to avoid the tax by this means will be stopped.

Written Debts

Under the law, before borrowed capital can be considered as invested capital, it must be a liability represented in writing. As a result of this requirement, the admonition, "Do right and fear no man; don't write and fear no woman" may become quite passé. The fact is that corporations that have adopted the invested capital method have, in many cases, been quite active in converting their non-written obligations into written form. Obligations to insiders, such as officers, stockholders, etc., are, of course, readily convertible. A tendency is also gradually developing on the part of some corporations of immediately issuing notes for their purchases in lieu of carrying open accounts, in order to get the invested capital benefit of such procedure. Also, in some instances, this situation has brought about a change in the relations between corporations and banks in respect to discounting of customers' paper. If customers' paper is merely discounted, no increase in invested capital results. If, instead of discounting the customers' paper, however, a corporation issues its own note with the customers' paper as collateral, invested capital is increased to the extent of the notes issued by the corporation. Thus, by a comparatively minor procedural change, invested capital is often enlarged by this process.

Investments

The advent of the excess profits tax appears to have resulted in significant changes in respect to the type of

securities purchased as investments by corporations. In the past, the basic criterion, whether bonds or stocks should be purchased by a corporation, pivoted primarily around investment factors. This is not so now; it is the tax factor that now frequently rules the roost.

When bonds are bought by a corporation, they represent part of its invested capital, but the interest it receives on them is fully taxed both for income and excess profits tax purposes. On the other hand, corporate stocks bought by a corporation are not included in its invested capital, but the dividends received on them are not taxed at all for excess profits tax purposes, and to the extent of only 15 per cent for income tax purposes. Accordingly, for corporations that use the base income method in computing their excess profits taxes, and who, therefore, do not care anything about their invested capital, there is a strong incentive to buy stocks instead of bonds. The reason for this, as previously indicated, is that the dividends which they will receive from such stocks will be wholly exempt for excess profits taxes and largely exempt for income taxes, whereas, if they received interest on bonds, they would be wholly taxable for excess profits and income tax purposes. On the other hand, corporations which use the invested capital method are in the opposite position. They will often find it desirable to convert stock investments into bonds, because stock investments are excluded from invested capital which, in many instances, results in an increase in tax out of proportion to the income received on the securities.

There is another phase of this investment situation. Because capital gains and losses do not enter into the excess profits tax computation, many corporations—and especially banks, insurance companies, and trust companies—find that they are much better off buying securities at a dis-

count and ultimately getting a capital gain, than buying high interest rate securities at a premium with ultimate capital loss. The effective return of the two securities may be exactly the same. There is one important difference, however, that in the instance where securities are bought at a discount, there is a lower amount subject to excess profits tax because the gain ultimately realized on this discount is not subject to such tax.

Another element in the investment situation in relation to the excess profits tax is the increase in the attractiveness of tax-exempt securities. With the acceleration in the tax rates, tax-exempt securities often yield a net return in excess of that on taxable securities, even for corporations which are on an invested capital basis and which must reduce their capital to the extent of the tax-exempts carried. For corporations that are not on the invested capital basis and have substantial profits subject to excess profits taxes, the investments in tax-free securities are of especial advantage.

Ownership and Reorganization

Closely related to the subject of investments is that of acquiring the entire ownership of corporations that may be said to have "tax appeal." Thus, for instance, there is an advantage for one corporation to take over another corporation that has had a satisfactory earning experience during the test period of 1936-39, for, obviously, this may result in securing a larger exemption to the acquiring corporation for excess profits tax purposes. One of the most popular indoor sports in recent months, however, is that of acquiring more or less defunct corporations that have large initial capital investments. Under the law, an operating

deficit of a corporation does not have to be taken into consideration in computing invested capital. Thus, if a corporation has \$10,000,000 of capital originally paid in and \$9,900,000 of deficit, its invested capital is not \$100,000, but \$10,000,000. Furthermore, if such a corporation has sustained operating losses during the past two years, those losses can be carried forward and applied against subsequent earnings. Also, if the corporation has not absorbed its excess profits tax credit in the past, these, too, can be carried forward and applied against subsequent earnings. It can be readily seen what tremendous tax appeal a corporation in this position may have.

Anyone acquiring such a corporation can, under present rates and without giving any consideration to any loss carry-over, or undistributed profits credit of previous years, filter into it some \$750,000 of excess profits income annually, and pay no excess profits tax whatsoever on such income. Thus, a corporation now having large earnings can, by acquiring such a company and filing consolidated returns, or merging or consolidating with it, often secure tremendous tax benefits. As a result of this situation, a sudden demand has naturally developed for this class of "lame duck" and near-defunct corporations with both Wall Street and Main Street participating in this activity. In fact, it has gone so far that specialists have sprung up in this type of transaction. Let me, in this connection, quote from a letter my firm recently received from one of these specialists:

Undoubtedly some of your clients are faced with the problem of excess profits tax because of the low capitalization of their companies.

I have several . . . corporations with large capital structures for sale where the stock can be purchased for a very reasonable amount. . . .

If any of your clients have the excess profits tax problem because of

small capital structures, some of these . . . corporations should be of interest.

I should be glad to talk to you further at your convenience.

Another phase of this "lame duck" corporate situation is that the excess profits tax may strongly affect the occasion, extent, or manner of corporate reorganizations. Where a company with a large capital investment is on the rocks and there would ordinarily be a new company organized, the influence of the tax is such as to make advisable the preservation of the existing company, and thus secure the benefit of the original capital investment, the carry-over of losses, and other factors already referred to.

Realization of Appreciation

I have already pointed out that under the law invested capital is limited to amounts paid into the business. The value of the business as such is not a factor. This means that if a business with, say, \$500,000 invested capital so develops that it is worth \$1,000,000, it is not entitled to the increase in value in figuring its excess profits taxes. As a result of this situation, corporations which have patents or other important assets that have appreciated in value are adopting various methods to secure the benefits of these increased values, not only for invested capital purposes, but for depreciation and other purposes as well.

One method is to sell the assets of the business to a new corporation at the increased value. Thus, if the business with a \$500,000 invested capital can sell its assets for \$1,000,000 to another corporation, the new corporation naturally becomes entitled to \$1,000,000 invested capital. It is true that the selling corporation will realize a gain of \$500,000. This gain would be taxable for income tax purposes under the law if other losses are not available to offset

it. The gain is not taxable for excess profits tax purposes, however, since capital gains are not a factor in the excess profits tax computations. Often the reduction in excess profits tax that results far outweighs any income taxes that are involved on the sale.

Another method that is being used to accomplish the same purpose is completely to liquidate corporations and then have the shareholders form new corporations. Under the law, the liquidation of a corporation is equivalent to the sale of the assets of the corporation to its shareholders. Thus, the shareholders realize a profit upon the liquidation, if the value of the assets of their corporation exceeds the cost of their shares. Such gain would, however, be taxable only as a capital gain and thus limited to 15 per cent of the profit if the shares were held for more than two years. Of course, if offsetting losses can be established, no tax whatsoever would be payable on the liquidation. If, then, a new corporation is organized by these shareholders, the new company not only gets an invested capital benefit through the inclusion of appreciation upon which the capital gain tax was paid, but also gets the benefit of an increased basis for depreciation, etc.

Along this same avenue is the procedure of complete disincorporation. As you know, the excess profits tax applies to corporations only. Partnerships and individuals are not subject to this tax. There is really little justification, except one of administrative convenience, for restricting the excess profits tax to incorporated business. In any event, the fact that individuals and partnerships are exempt from excess profits taxation has resulted in an avalanche of disincorporations and liquidations. This "out" is, of course, not available to public companies. However, small- and

middle-sized corporations with comparatively few shareholders are in large numbers giving up the corporate ghost.

Inventory Methods

Even before the adoption of the excess profits tax, a growing number of companies turned to the so-called "elective" or "last-in first-out" method of valuing their inventories. Under this method, the cost assigned to any given unit of sales is the cost of the most recent purchase. Since costs are advancing, this means that the high cost items are offset against current sales and, therefore, eliminates any profits on inventories carried over at valuations below current market prices. In other words, this method provides a brake on inventory profits and a cushion against inventory losses. Since it reduces profits during up-swings, it also reduces income taxes during this period. Since the steepness of the excess profits tax has accentuated the tax saving from the adoption of the "last-in first-out" method, this method is rapidly gaining favor.

Regardless of the tax phase of this matter, the increasing consideration given this method of inventory valuation by business men and their accountants is a desirable development, for it tends to smooth out inventory fluctuations and thus aids in the elimination of unusual profits and losses on inventories.

CONCLUSION

The points in the foregoing discussion are but a few examples of the many influences of excess profits taxation on business policy. Some of these influences result entirely from infirmities in the law and may be corrected, whereas others are inherent in the fundamentals of excess profits taxation itself and little can be done about them.

There is, however, one phase of the present excess profits tax situation about which it appears that something can be done. A tax student examining the present law will, I think, readily conclude that it is basically inequitable and unsound. It is really nothing but the first World War tax system over again with some of the cobwebs brushed off. In fact, it is seriously inferior to the World War excess profits tax in many respects. Now, as has been said elsewhere, if we limit taxation today to the methods used in the first World War, we will be making as great a mistake as it would be to send General Pershing's 1918 army, equipped as it was then, into the field against Hitler's 1941 mechanized divisions.

The major fault with the present act is that it literally writes profiteering into law. This is accomplished by giving corporations the option to establish unusually high deductions in computing excess profits taxes. As I have already indicated, the tax rates only begin to operate after profits have passed the average earnings in the four-year base period, 1936-39, or if earnings have passed an eight per cent return on the first five million dollars of invested capital and a seven per cent return beyond that amount. The way this formula works out, the strong corporations inevitably will become stronger and the weak ones weaker.

Corporations that were fortunate enough to make large earnings in the pre-emergency period, or which are over-capitalized, can, under this formula, earn big profits without paying any excess profits taxes. This means that the railroads, the heavy industries, and many other "war baby" corporations, which are really getting the major benefits of war orders, escape this tax almost completely. Thus, for instance, United States Steel, whose profits in the preceding four years had averaged about \$46,000,000, had a net in

1940 of \$102,000,000, and did not pay a penny in excess profits taxes. Republic Steel, with a four-year average of \$7,000,000, passed a \$21,000,000 net in 1940 and went excess profits tax free. The railroads, whose profits have enormously increased as a result of the defense program, have to date escaped the excess profits tax almost completely.

On the other hand, many of the smaller companies that are not receiving war orders and that are just getting on their feet find that most of their earnings are considered "excess" in comparison with the poor showings during prior years, and are, accordingly, heavily taxed. This is a case of taking it from the "butter" and giving it to the "guns" with a vengeance. It is an amazing situation in view of the antiwar millionaire label that was attached to this tax.

A sound taxing program should, to my mind, tax "excessive" profits as well as "excess" profits. In other words, "normal" excessive peacetime earnings should be subjected to excess profits taxes apart from the question of increased earnings. The fact that a corporation earned 20 or 30 per cent, or more, on its invested capital in the past should not, during this emergency, give it the privilege of continuing at that rate. Such a taxing program entrenches those corporations which possess a monopoly position in our economy.

Furthermore, a corporation that seldom makes a substantial rate on its capital should not be exempted from excess profits taxation if its earnings are increased, even though the increased earnings represent a low ratio to its invested capital. Personally, I think this is a time when excess profits should be taxed at the highest possible rate consistent with maximum production. To my mind, we

must, under existing conditions, not only forget business as usual, but profit as usual. The morale of labor, consumers, and draftees cannot be preserved if the national emergency is to be turned to private profit. Furthermore, apart from the social desirability of taxing away excess profits, we cannot afford to risk the public upheaval which would certainly accompany a bumper crop of defense millionaires. It is doubly important in these days of strain and tension that our tax policies be designed with the broad objective of preserving our economic system, and at the same time striking at the roots of abnormal and monopoly profits.

PART THREE

CONTROL OF INFLATION THROUGH REVENUE POLICIES

CHAPTER IV

GENERAL SALES TAXES AND SELECTIVE EXCISES

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A DECADE of hard times has brought a galaxy of federal and state commodity taxes and excises, and the shot-gun marriages of half the states to general sales taxes. Whether or not we like these ubiquitous pickpockets, they are here—and are likely to stay awhile. Unpalatable as the conclusion may be, still heavier indirect taxation is probable if Congress imposes a tax program that is adequate in view of its expenditures, and that will check inflation.

FISCAL SIGNIFICANCE OF CONSUMPTION TAXES

Sales and commodity taxes of all kinds produced 25 per cent of total federal, state, and local tax revenue in 1939, or prior to the recent changes in federal excises. In fiscal 1941, excises constituted 33 per cent of federal taxes, while 40 per cent of total state tax collections was derived from general sales and commodity taxes. The gasoline tax provided 20 per cent of total state taxes, general sales taxes 12 per cent, alcoholic beverage taxes 5 per cent, and tobacco taxes 2.5 per cent. Because of diversity in revenue systems, the proportion of state tax collections derived from sales and commodity taxes naturally varies widely. To illustrate, Mississippi, one of the 23 general sales tax states in 1941, obtained 65 per cent of state taxes from sales and

commodity taxes, whereas the average for the 48 states was 40 per cent.

The disparity in state revenue systems should be borne in mind when considering the relative tax burden on different income groups. General sales taxes, and most of the excises, are regressive in incidence or bear more heavily in proportion to income on the lower income classes.¹ A notable monograph of the Temporary National Economic Committee, based on a study of 1938-39 taxes, indicated that both the federal revenue system, and state and local taxation as a whole, were regressive in the lowest income groups. The average taxes borne by the income class below \$500 were equal to 21.9 per cent of income, whereas, for those with incomes between \$2,000 and \$3,000, the average taxes amounted to 17.5 per cent of income. The results of the investigation indicate that relative to income, the middle classes were being taxed least.²

It must be remembered, however, that these estimated percentages are *averages*, and thus conceal individual differences in spending habits as well as variations in state and local revenues. The figures are based on a composite of all such revenues for the entire country. Taxation will be more regressive in states relying heavily on sales taxes than in states having no general sales tax but a progressive personal income tax.

After this brief mention of the significant role already attained by states sales and commodity taxes, the remainder of the discussion will be devoted to federal taxes on consumption. Federal deficits, accompanied by the financing

¹ Cf. Mabel L. Walker, *Where the Sales Tax Falls*. James W. Martin, "Distribution of the Consumption Tax Load," *Law and Contemporary Problems*, VIII (Summer 1941), 445-56.

² G. Colm and H. Tarasov, *Who Pays the Taxes?* Monograph No. 3, Temporary National Economic Committee, p. 6.

of defense largely by federal borrowing from commercial banks, constitute a threat of serious inflation. Consideration of general sales taxes and selective excises in connection with revenue policies to prevent inflation, therefore, can be centered on the use of these taxes by the federal government. The latter has not yet resorted to a general sales tax. As this is a possible new source of revenue, it will be discussed later, after our examination of excises which already constitute a major segment of the federal revenue system.

FEDERAL EXCISES

The Constitution gives Congress the power to "lay and collect taxes, duties, imposts and excises." Judicial interpretations of the meaning of the term "excise" as used in this phrase have not always been clear. For instance, the Supreme Court on certain occasions has held that an income tax is an excise, and in other decisions that it is not an excise.³ In general, excises are internal taxes as distinguished from custom duties. They are taxes imposed upon the production, sale, consumption, or use of specified commodities, and hence are distinguished from general sales and turnover taxes. Finally, various taxes levied on specified acts and privileges are commonly included with excises.

The federal taxes on admissions to places of amusement, club dues, the new use tax on motor vehicles and boats, the stamp taxes on certain legal documents and on the transfer of securities, the tax on the rental of safety deposit boxes, and a host of other "miscellaneous" taxes are usually

³ *Flint v. Stone Tracy Co.*, 220 U. S. 109 (1911); *Springer v. U. S.*, 102 U. S. 586 (1880). An opposite conclusion was stated in *Pollock v. Farmers' Loan and Trust Co.*, 157 U. S. 429 (1895).

dumped into the catchall category of excises. As used here, federal excises include all existing internal revenue taxes except net income taxes, estate and gift taxes, the capital stock tax, the excess profits taxes, the tax on unjust enrichment, and the employment or payroll taxes.

TABLE 1

YIELDS FROM FEDERAL EXCISES COMPARED WITH TOTAL INTERNAL REVENUE,
1929-41

Fiscal Year Ending June 30	Total Excises	Total Internal Revenue	Percentage of Internal Revenue Derived from Excises
1929	\$ 545,883,000	\$2,939,054,000	18.6
1930	565,117,000	3,040,146,000	18.6
1931	520,111,000	2,428,229,000	21.4
1932	453,550,000	1,557,729,000	29.1
1933	838,738,000	1,619,839,000	51.8
1934	1,659,277,000	2,672,239,000	62.1
1935	1,890,025,000	3,229,436,000	58.5
1936	1,618,929,000	3,520,208,000	46.0
1937	1,764,561,000	4,653,195,000	37.9
1938	1,730,852,000	5,658,765,000	30.6
1939	1,768,113,000	5,181,574,000	34.1
1940	1,884,512,000	5,340,452,000	35.3
1941	2,399,418,000	7,370,108,000	32.6

Source: Bulletin of the U. S. Treasury Department, August, 1941, p. 40.

Prior to World War I the federal government was supported almost entirely by excises and custom duties. During that war, the excises became relatively less important, despite the imposition of a large number of new ones and increases in existing rates, because of the high yields of the new net income and excess profits taxes. During the 1920's, with the exception of the taxes on tobacco, excises were comparatively unimportant from the fiscal standpoint. The Eighteenth Amendment stopped the flow to the Treasury of the lucrative taxes on alcoholic beverages, and

many of the war excise taxes were removed or the rates reduced.

There have been notable changes in federal excises since 1929. Although the yield of these taxes dropped by \$112,000,000, or nearly 20 per cent, from 1930 to 1932, the proportion of internal revenue consisting of excises rose from 18.6 per cent in 1930 to 29.1 per cent in 1932. This reflects the much greater decline in yield of the other taxes, particularly the income tax. As a result of the imposition of many new levies, particularly the return of liquor taxes, and tax rate increases, the revenue from excises had an extraordinary rise after 1932, both in absolute amount and relative to other internal revenues. In 1933, the yield of excises increased by \$385,000,000 or nearly 85 per cent, but the continued decline of other taxes caused total internal revenue collections to be only \$62,000,000 above the preceding year. Excises produced 51.8 per cent of the total internal revenue in 1933 and 62.1 per cent in 1934. If the agricultural processing taxes are excluded, excises produced 48.2 per cent of the total internal revenue in 1934, 42.2 per cent in 1935, and 44.0 per cent in 1936. Because of the elimination of the agricultural processing taxes and the business recession of 1937, the yield of excise taxes dropped by \$159,000,000 from 1935 to 1938. The excises produced only 30.6 per cent of the total internal revenue in 1938 as compared with 62.1 per cent in 1934. This remarkable shift in their relative fiscal importance was the result of the rise in other internal revenues, especially the income tax.⁴

The Revenue Act of 1940 made numerous changes in the excise taxes and raised most of the rates about ten per cent.

⁴ Statistics on the yield of excise taxes and the proportion of total federal taxes derived therefrom for the years 1911 to 1940, inclusive, are contained in the July, 1941, issue of *Tax Policy*, "Wrestling with Excises."

These changes, effective July 1, 1940, together with the greater prosperity engendered by defense spending, caused excise collections to rise to \$2,400,000,000 in fiscal 1941, an increase of \$515,000,000 over the preceding year. Yet the proportion of the internal revenue consisting of excises was only 32.6 per cent in 1941. The total revenue from customs duties in 1941 was \$392,000,000, or only 5 per cent of all federal taxes.

The composition of the federal excises is shown in Table 2. The taxes on three commodities, alcoholic beverages, tobacco, and gasoline, provided 78.6 per cent of the total revenue from excises, and 25.3 per cent of the total internal revenue. If the taxes on lubricating oils, tires and inner tubes, trucks, automobiles, motorcycles, and parts and accessories are added to the gasoline tax, the federal motor vehicle taxes produced the sum of \$537,500,000 in 1941. This represents 22.4 per cent of the total excise taxes and 7.3 per cent of all internal revenue.

The Revenue Act of 1941 increased the taxes on distilled spirits, wines, playing cards, safe deposit boxes, tires and tubes, admissions, cabarets, club dues, automobiles, trucks, busses, automotive parts, radio receiving sets, phonographs and records, musical instruments, mechanical refrigerators, matches, and telegraph, telephone, radio, and cable messages.

In addition, several new excises were imposed. These include manufacturers' taxes at the rate of ten per cent on sporting goods, luggage, electric, gas, and oil appliances, photographic apparatus, electric signs, business and store machines, rubber articles, commercial washing machines, and optical equipment. A tax of six per cent is levied on the amount paid for local telephone service. A new departure in federal excise taxation is represented by taxes

imposed on *retailers* at the rate of ten per cent on sales of jewelry, furs, and toilet preparations. Another new excise is the tax of five per cent on the amount paid for passenger

TABLE 2
FEDERAL EXCISE TAX COLLECTIONS, FISCAL 1941

	Amount	Percentage of Total Excises
Alcoholic beverages.....	\$ 820,056,000	34.2
Tobacco.....	698,077,000	29.1
Gasoline.....	343,021,000	14.3
Automobiles and motorcycles.....	81,403,000	3.4
Other motor vehicle taxes.....	113,106,000	4.7
Sugar Act of 1937.....	74,698,000	3.1
Admissions.....	70,963,000	3.0
Electrical energy.....	47,021,000	2.0
Stamp taxes.....	39,057,000	1.6
Telephone and telegraph.....	27,331,000	1.1
Processing coconut and vegetable oils.....	23,186,000	1.0
Mechanical refrigerators.....	13,279,000	0.6
Radio sets.....	6,935,000	0.3
Toilet preparations.....	6,683,000	0.3
All other.....	34,602,000	1.3
Total.....	\$2,399,418,000	100%

Source: *Bulletin of the U. S. Treasury Department*, August, 1941, p. 42.

transportation by rail, motor vehicle, water, or air. Fares not exceeding 35 cents are exempt. A tax of \$10 per year is imposed on each "pin-ball" or similar amusement machine, while the tax on each "slot-machine" is \$50 per year. A special tax of \$10 per year is imposed on the operator for each bowling alley, billiard table, or pool table. Another innovation in federal taxation is the use tax of \$5 annually on each motor vehicle used for highway transportation. An annual use tax varying from \$5 to \$200 is levied on the owners of noncommercial boats. These use taxes are to be collected directly from the owners of motor vehicles and boats.

Certain other excises recommended by the House Ways and Means Committee were not adopted. These were taxes on soft drinks, outdoor advertising, and commercial radio broadcasting.

As a consequence of the changes in rates, the new taxes provided in the Revenue Act of 1941, and the rise in the national income, the excise taxes are expected to produce a billion dollars of additional revenue in a full year of operation. Most of the changes in excises became effective October 1, 1941.

A NATIONAL GENERAL SALES TAX?

Several nations have general sales taxes of some kind, many of which were adopted during World War I. This type of tax received little attention in this country until after the war, when a vigorous attempt to introduce a national sales tax failed. As an emergency depression measure, a bill proposed in 1932 by the House Committee on Ways and Means for a manufacturers' sales tax similar to that of Canada was defeated. Proposals for a national sales tax have since been heard repeatedly but have had little support in Congress.

Of the various kinds of sales taxes, the one usually proposed is the manufacturers' sales tax. It would be paid but once on any commodity, and thus avoid the pyramiding effect objectionable in multiple turnover types of sales taxes. By collection from the manufacturer, instead of from the retailer as in the case of the state sales taxes, the number of taxpayers would be very much smaller, making the tax easier to administer and less costly to collect.

If such a tax were to be adopted, should it be in addition to present excises or replace most of them? Where excises are retained, should the commodities thus taxed also be

subject to the general sales tax? What exemptions should be allowed? Should sales of food be exempt to make the tax less regressive? What rate should be levied? How much revenue could the tax be expected to produce? How would it be administered? What would be the effects on existing state sales taxes? The advocates of a federal sales tax must consider such questions as these.

The yield of a national sales tax would depend upon the base, rates, and exemptions adopted, the national income, and other tax collections. It was estimated that the manufacturers' sales tax bill defeated in 1932 would have raised \$595,000,000 the following year. This was a tax of two and one-quarter per cent of the price at the factory or place of production, and exempted staple foodstuffs, farmers, and manufacturers and producers with annual gross sales of less than \$20,000.⁵ The Treasury Department estimated in 1936 that a five per cent manufacturers' sales tax with food, clothing, and medicine exempt, would at that time produce an annual revenue of \$910,000,000.⁶ The National Retail Dry Goods Association in 1941 urged Congress to adopt a manufacturers' sales tax. Its representative estimated that on the basis of the 1939 Census of Manufacturers, a three per cent tax exempting food and drugs would produce practically a billion dollars.⁷ The National Association of Manufacturers, long noted for its advocacy of the sales tax, recommended in 1941 that Congress adopt either a federal tax on retail sales, or a general manufac-

⁵ Statement of Colin F. Stam, Chief of Staff of the Joint Committee on Internal Revenue Taxation, U. S. House of Representatives, Committee on Ways and Means, *Hearings on Revenue Revision of 1941*, I, 86.

⁶ U. S. House of Representatives, Committee on Ways and Means, *Hearings on the Revenue Act of 1936*, p. 623.

⁷ Statement of Jay Iglauer, Chairman of Taxation Committee of the National Retail Dry Goods Association. U. S. Senate, Committee on Finance, *Hearings on the Revenue Act of 1941*, p. 204.

turers' excise tax on products at the point of final manufacture. The spokesman for the Association would not suggest what rate should be used or what exemptions should be allowed, but thought that a one per cent general sales tax would produce between \$500,000,000 and \$750,000,000.⁸ No explanation was offered as to the basis of this estimate, and in view of the others previously mentioned, it is probably too optimistic.

The rate of a general sales tax to replace existing federal excises would have to be much higher than the present maximum state sales tax rate of three per cent. It will be recalled that \$2,400,000,000 was collected from excises in 1941, and that the changes in the Revenue Act of 1941 are expected to add another billion annually. The amount of revenue involved is so large, and the change would necessitate so many adjustments, that the replacement of existing excises with a general sales tax would be highly inexpedient, especially at this time.

The substitution of a manufacturers' sales tax for the present array of excises, however, would greatly simplify the federal revenue system, and perhaps facilitate administration by replacing a multitude of different taxes with a uniform tax. To increase the yield, Congress would need to raise but one rate instead of making dozens of specific changes in excises as occurred in 1940 and 1941. This should also eliminate much of the confusion resulting from the stream of delegations appearing before Congressional revenue committees, each man telling why the tax on his industry is bad.

Some people favor a general sales tax because a uniform

⁸ Statement of L. W. Houston, Chairman of the Committee on Government Finance of the National Association of Manufacturers. U. S. House of Representatives, Committee on Ways and Means, *Hearings on Revenue Revision of 1941*, I, 553, 562.

rate "would treat every commodity and industry alike," and would be a tax for revenue only and not for some ulterior purpose. The use of a uniform rate does not insure that everyone is treated equitably, and in fact is more likely to have the opposite effect. A ten per cent tax on fur coats by no means has the same effects as a tax of ten per cent on milk and bread. A distinct advantage of excises over a general sales tax is that they can be selected to tax luxuries more heavily, or to aid the defense program by restricting consumption of resources essential for defense.

REGULATORY AND LUXURY TAXES

Some well-known authorities on public finance lay down with pontifical assurance the edict that a tax should never be used for a nonfiscal purpose, and that to do so is unsound finance. Such an expert sometimes has a convenient lapse of memory, however, and advocates the use of certain taxes to make people tax conscious, or heavier taxes on hard liquor than on beer to discourage consumption of the former. Similarly, some industrialists and business men expound that sound principles require taxation be used for the sole purpose of producing revenue—except, of course, the protective tariff.

Many doubt, however, that these gentlemen hold a monopoly on knowledge of what constitutes "sound finance." Whether intended or not, taxes do have other effects than the production of revenue. If possible, taxes should be chosen which have desired effects. At the present time, the defense program can be aided not only by large revenues, but also by taxes that assist in diverting resources to the defense effort. Raw materials, such as steel, aluminum, copper, and rubber, are essential for the production of ships, tanks, planes, and guns. In addition

to priorities and rationing, especially heavy excises may well be imposed on those consumers goods competing for raw materials and labor needed by defense industries.

The federal excises may be classified in three groups: (1) those on commodities of mass consumption such as tobacco and beer not competitive with defense; (2) the luxury taxes such as those on furs, and jewelry; and (3) taxes on durable consumers goods requiring resources needed by defense industries. As we have seen, most of the revenue is derived from the first group of excises, but the Revenue Act of 1941 gave greater emphasis to those in the second and third groups. Although the taxes on motor vehicles, parts, and accessories were hoisted, they might well have been more severe. Instead of a tax of only 7 per cent on the manufacturer's price of passenger automobiles, there is good reason to make it 20 or 25 per cent. Automobiles not only absorb essential raw materials and labor, they are in the nature of a luxury which can be curtailed in wartime, as the people of Britain have discovered.

Selective excises rather than a general sales tax offer a means of imposing heavier taxes on goods and services considered to be luxuries. Such excises can be levied with the primary purpose of producing revenue rather than restricting consumption of the goods taxed, but regardless of the dominant motive, the taxes probably would have both results. Both the point of maximum revenue and the degree of restriction of consumption would depend upon the size of the excise and the elasticity of demand of the thing taxed. Luxury taxes are commonly defended as an additional way of reaching taxpaying ability. There is no clear line of demarcation between a luxury and a necessity—what one person might consider a luxury, another would

insist was a necessity. Despite the lack of any scientific distinction between these two categories, however, it might be agreed that heavier taxes could justifiably be imposed on certain items such as furs, jewelry, automobiles, and yachts, because their purchase indicates superior purchasing power. Such a presumptive index of ability is crude compared with net income, it is true, but it is not unreasonable to contend that a person should not buy such luxuries unless he is able to pay for them. At any rate, if their price includes a sizeable tax, the individual need not buy unless he chooses.

Selective excises could be imposed on goods selling above a designated price; for example, shoes selling for more than \$5 or automobiles with prices exceeding \$900. There would be some difficult administrative problems and no little unjust discrimination resulting from the establishment of arbitrary price divisions between taxed and untaxed goods of the same kind. The latter objection could be obviated in part by applying the tax only to the excess of the selling price above a fixed exemption. Thus the federal tax on theater tickets formerly was one cent for each 10 cents of the price in excess of 20 cents. Similarly, a tax might be levied on employers of domestic servants, private gardeners, chauffeurs, stablemen, etc., at a rate of, say, 10 cents per day per employee for each employee in excess of one. This might be as logical a luxury tax as one on their yachts or champagne.

Much printer's ink is being used on discussions of taxation to check rising prices. It would help hold down the cost of living if some commodity taxes were repealed. Herr Goering should have another medal for coining the phrase "guns or butter" to impress on the Germans the sacrifices in living standards they would be compelled to face.

In this country perhaps we can have both butter and guns, but if not, we could at least have fairly good butter substitutes at low prices by removing the various federal and state taxes on oleomargarine⁹ and similar products, and the processing taxes and import duties on coconut and other imported vegetable oils. The "infant" dairy industry might well be weaned and consumers given their turn at protection. If the various duties and quotas were removed from sugar, wool, shoes, textiles, and a host of other commodities, consumers could buy them at lower prices.

CONSUMPTION TAXES AND INFLATION

Until recently, the discussion of sales and excise taxes gave little consideration to their relation to the problem of inflation. The primary arguments for them were: (1) they bring in the money; (2) there is little popular objection to them, especially when hidden in prices; (3) they broaden the tax base by reaching the low income groups; (4) they contribute to the diversity, flexibility, and elasticity of the revenue system; and (5) they are usually economical and easy to administer. The principal objections were: (1) they are usually regressive in incidence; (2) they do not contribute to tax consciousness, especially if hidden in prices; (3) they result in inequalities because of differences in the degree of shifting; (4) the true cost of administration is much higher than supposed, because business firms serve as tax collectors without compensation from the government; and (5) excises retard production by checking consumption.

These traditional objections to consumption taxes should not be forgotten even in wartime, but the situation today

⁹ Cf. J. Wilner Sundelson, "Banning the Use of Margarine Through Taxation," *Tax Barriers to Trade*, pp. 85-104.

calls for a somewhat different approach. The primary consideration should be success of the national defense program. This depends upon the rapidity and effectiveness of providing the necessary manpower, equipment, and other essential materials and services to make our country impregnable. In these circumstances, undue solicitude for equity must, if necessary, give way to fiscal adequacy, taxes to help divert productive resources to defense industries, and a fiscal program to assist in preventing an excessive rise in prices. In a conflagration, a meticulous regard for justice and the sanctity of private property is worse than foolish, if setting a backfire is the best way to stop a greater destruction. It is true that most sales and excise taxes, especially those that bring in the most money, are regressive, but there can be worse alternatives than violation of the ability-to-pay principle of taxation.

According to revised estimates released by the Budget Director on October 4, 1941, total federal expenditures of 24.5 billion dollars were anticipated in fiscal 1942; tax collections were expected to total 12 billion dollars, leaving a prospective deficit for the year of 12.5 billion. The borrowing to cover federal deficits is by sale of government securities, not only to those who purchase them with savings but also to commercial banks. Large purchases by the latter are likely to expand bank credit, and this creation of new checkbook money may easily lead to another calamitous inflation as it did in World War I. Since August, 1939, the Bureau of Labor Statistics' index of prices of 28 basic commodities has already risen 55 per cent. The stage is set whereby deficit financing and bank credit expansion, unless checked, can accelerate and give momentum to the upsurge of prices.

It is questionable if the impending inflation can be con-

trolled by revenue policies alone, by monetary and banking policies alone, or by government price fixing alone. The situation now demands intelligent, coordinated, and vigorous action along all fronts, and not merely the adoption of another tax bill by Congress. There is desperate need, however, to raise more money by taxation in view of the appalling size of present and contemplated expenditures for defense. One need not be a balance-the-budget fanatic to see the folly of failing to reduce the stupendous deficits we are facing. A much larger proportion of this spending must be met with taxes.

A larger aggregate revenue will be collected if consumption taxes are used extensively as well as other taxes. To produce the same amount of revenue by increases in direct taxes alone would necessitate rates so high an elected Congress would not dare impose them. It is no new observation that indirect taxes, especially if hidden in prices, produce less complaint in proportion to revenue than direct taxes. Hidden taxes have the psychological advantage, to a considerable extent, of being a method of painless extraction. Of course, the toothache is really there just the same, but if one does not feel it so much, that may be sufficient reason for using the anesthetic. We are discussing this question in the shadow of staggering deficits. Heavy direct taxes must be the chief reliance in wartime, but from a practical standpoint, indirect taxes must also be employed extensively to raise sufficient revenue.

Furthermore, as a check to inflation, still heavier taxation and probably some plan of forced saving is required to absorb the expanded purchasing power resulting from the defense spending boom. The transfer of purchasing power to government prevents excessive private spending and its resultant bidding up of prices. As indicated above,

consumer taxes help maximize tax collections. The brake on inflation will tend to be more effective, the larger the total amount of revenue extracted.

To the extent that it provides revenue which reduces the amount of inflationary borrowing, any tax tends to check the rise in the general price level, but all taxes do not have the same effects on individual prices. Some taxes, such as those on net incomes and excess profits, have little or no tendency to raise prices, because they do not materially affect the marginal firms.¹⁰ On the other hand, most of the excises and sales taxes are added costs of doing business to marginal as well as other sellers, and are likely to be shifted in higher prices. From this it might appear that such taxes, by causing prices of the taxed goods to be higher, actually are inflationary. The tax on a commodity obviously does not increase consumer incomes. To the extent that the tax yields revenue to the government and is borne by consumers in higher prices, it leaves them less to spend on other things or to be saved. Unless savings are reduced by an amount equal to the yield of the tax, which is not likely, the reduction in consumer purchasing power left for other purchases is reflected in a relatively decreased consumer demand for the latter, and a tendency toward a relative decline in their prices. The government spends the money taken from consumers by the tax, probably differently than they would have spent it, and this in turn may tend to raise certain prices. But like any other tax, a sales tax or excise represents a transfer of purchasing power, and not an increase in its aggregate amount. Moreover, the price increases resulting from such taxes are definitely limited by the size of the tax. Even if a general

¹⁰ Cf. National Industrial Conference Board, *The Shifting and Effects of the Federal Corporation Income Tax*, 1928.

sales tax on all commodities did raise their prices by the amount of the tax, it could have only a relatively small effect on the general price level.

When sales and excise taxes raise the cost of living of working men, this may provide an excuse for more vigorous demands for wage increases. To the extent that these demands are successful, the higher wages add to the cost of production and thus tend to raise prices still further. It should be emphasized, however, that the taxes do not give the workers any additional power to obtain the wage increases in such cases, but merely serve as an incentive to exercise existing bargaining power.

Consumer taxes involve other problems which must be omitted here. They have distinct disadvantages, while their productivity is their chief merit. They have a place as part of a tax system to provide sufficient revenue to finance national defense and help check inflation.

CHAPTER V

ROLE OF INCOME AND PROFITS TAXES IN THE CONTROL OF INFLATION

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INCOME AND profits taxes have a role to play in the control of inflation in the United States, but the sooner it is realized that it is only a minor role, the better it will be for the national welfare—for inflation is close at hand. In September of this year, the national income reached a rate equivalent to 92 billion dollars a year, according to figures published on November 11 by the United States Department of Commerce. But already rising prices were beginning to outrun increased incomes, except in farming.

The Economist of London, a weekly which often sees us more clearly than we can see ourselves, said recently that "the United States . . . is perhaps in more danger of inflation than any one of the belligerent nations." The writer continued:

The reason is not to be found in the general implications of the "quantity theory" or even in the possession of large excess reserve balances by the member banks of the Federal Reserve System. It rather lies in the fact that the United States still lacks the array of anti-inflation devices, a closed capital market, high taxation, civilian rationing and control of essential prices, wages, and profits the belligerent nations have all imposed.¹

¹ October 18, 1941, p. 476.

This enumeration of anti-inflation devices puts income and profits taxes in true perspective. They are important elements of a protective system, but of themselves alone they are almost helpless to stop the rushing advance of prices. Income and profits taxes reach the inflation problem from one side alone, that of purchasing power in the hands of the public. On the other side, the commodities side—where goods are scarce, the scramble to get them begins, and prices start to jump—high income taxes have been found in country after country to be almost impotent to alter the trend.

The effort made in recent months to attack the income side of the problem, and to mop up increased purchasing power through taxation, will serve useful ends. But the additional income and profits tax imposed under the Revenue Act passed by Congress in September, 1941, will bring in only a sum which is insignificant when it is compared with the current expenditures for defense. As anti-inflationary devices the new taxes will probably be more than offset by the increase in farmers' incomes which has been assured by the Congressional agricultural price policy. Again, as anti-inflationary devices, they are likely to be obliterated by increases in wages.

THE CANADIAN EXPERIMENT

Canada is the most recent and the nearest of the countries already at war to recognize the fact that high income and profits taxes are inadequate barriers to inflation. Canada has tried hard to stretch these taxes to their limits, and from the fiscal point of view she has profited, although, as it turned out, the rising tide of prices could not be halted by these means. The Dominion has succeeded in meeting a remarkably high proportion of expenditures by taxation

—about three-fourths of the total if aid to Britain is excluded. The most productive of the Canadian wartime tax increases have been in the field of income taxation, with the result that the income tax share of the total federal yield has risen from less than one-third to more than one-half, and the income tax yield in dollars has been multiplied by five.

The Canadian income tax has been broadened at the base much as the American federal tax has been broadened, so that, for example, a married man with no children earning \$2,000 a year, who formerly paid no income tax to the Dominion government, now pays \$175 a year. As for profits taxes, the Canadian minimum corporation rate is now 40 per cent, as compared with the nominal maximum rate of 31 per cent in the United States. In Canada the excess profits duties are also severe.

In spite of these increased taxes, the Canadian price level has continued to rise, although at a less rapid rate than in Great Britain (where income and excess profits taxation is even harsher). The Canadian problem has been further complicated by the near presence of the United States, which is recognized to have done little more than tinker with the problem of inflation from time to time. "If inflation comes to the United States we cannot save ourselves" has been said and written over and over again in Canada. Not long ago the time came when the Dominion felt it could take no more chances. Wages and prices were frozen. The price control plan went into effect on December 1, 1941, and the wage control plan was installed two weeks before.

When Canadian Prime Minister W. L. Mackenzie King broadcast the wage- and price-fixing decision to the people on October 18, 1941, he indicated the helplessness of high

taxes to stop the tide of inflation, although he did not discuss taxation as such. The Prime Minister said:

We have heard much in recent weeks about rising prices. They have affected the budget of every family in Canada. We have heard and seen something of the dangers of inflation. . . . Prices are rising . . . because the public has more money to spend and there are less of the things people wish to buy. For two years the Government has been competing with the individual consumer for almost every commodity Canada produces or imports. . . . We sometimes forget that the same sheet of aluminum cannot be used to make a plane and to make pots and pans. . . . The same pound of cheese cannot be eaten in Britain and in Canada.

After reviewing the commodity-by-commodity price control used in Canada up to the time of wage fixing and price fixing, the Prime Minister phrased the reason for its abandonment as follows:

To continue to attempt to control the rise in prices, piecemeal, might only serve to augment the very evil it is desired to avoid by occasioning, through fear of the future, a precipitate rise in the prices of those commodities which are not already controlled.

Obviously Canada's high income and profits taxes had failed to reduce purchasing power perceptibly, even though individual surpluses in Canada tend to be smaller than in the United States. Nor had high taxation appeared to touch the problem of the scramble for increasingly scarce commodities except where prices were controlled. It is too early to prophesy the success or failure, or half-success or half-failure, of the Canadian freezing order. Whatever its fortunes, it represents an attempt to cope with an inflationary situation by gripping it instead of tinkering with it.

NAZI CONTROLS

So much for the decision recently made by our near neighbor. The decisions made by Germany long ago—for

Nazi war finance was completely planned out when much of the rest of the world believed that peace was permanent—indicate the same point of view, namely, that while income and profits taxes are an important part of a war economy, for fiscal and political reasons, inflation must be halted by a far more comprehensive and far more rigid system. Furthermore, it must be a *system*, not a series of unconnected devices.

In Germany, wholesale prices, retail food prices, and the cost of living have all been kept down to three or four per cent above their level in August, 1939. This result has been achieved through the German price-control system which had been in such successful operation for so long a time before war broke out, that after September, 1939, few changes were necessary.² On September 4, 1939, an ordinance was issued freezing wages, salaries, and working conditions at the prewar level. It was further provided that prices of goods and services must not exceed the prewar level, and that if any gain should result from the wage-fixing order, they should be reduced accordingly. Strict rationing of essential commodities and the allocation of supplies by government agencies are also employed in Germany. These devices are, of course, an essential adjunct of a price control system.

When the time came, Germany made use of increased income and profits taxes. Detailed budget data have not been published since the Nazi rearmament program was undertaken, but it is known that income taxes have been increased and their yield improved, and that the tax on corporation profits was increased to 37.5 per cent and 55

² Louis Domeratsky, "Price Control in Germany—Policy and Technique," *International Reference Service*, U. S. Bureau of Foreign and Domestic Commerce, I (April, 1941), 10.

per cent, according to the size of income, in August, 1941.³ The changes in the Reich tax structure appear to have been made almost wholly for political and fiscal reasons and to have little connection with the control of inflation.

The Nazi government is accustomed to boast to listeners abroad of the stability of domestic prices and the absence of inflation that have been achieved through its measures of price control. To the present argument it is immaterial that acute shortages of domestic materials are believed to exist within the Reich. The failure to use income and profits taxes to control inflation is the point to be emphasized here.

THE KEYNES PLAN IN BRITAIN

In Great Britain, where sustained attention has been given to what is usually called the "inflationary gap" in the budget, use was made of high income and excess profits taxes before it was realized that price controls, rationing, and other forms of consumer regulation, were necessary for the control of inflation. Rationing and its accompanying measures were at first seen, apparently, merely as safeguards of consumer supplies for an island which must get most of its food by way of the high seas. John Maynard Keynes saw a little farther than this, but not far enough. His scheme for the compulsory saving of increased war incomes, first published in *The Times* of London in November, 1939, and republished in book form in this country in the late spring of 1940, was concentrated on withdrawing purchasing power from the public in wartime and restoring it in the probable postwar depression. Mr. Keynes lined up the alternatives as follows:

³ *The New York Times*, August 25, 1941, p. 23.

The increased quantity of money available to be spent in the pockets of consumers will meet a quantity of goods which is not increased. Unless we establish iron regulations limiting what is to be sold and establishing maximum prices for every article of consumption, with the result that there is nothing left to buy and the consumer goes home with the money burning his pocket, there are only two alternatives. Some means must be found for withdrawing purchasing power from the market; or prices must rise until the available goods are selling at figures which absorb the increased quantity of expenditure—in other words the method of inflation.⁴

More briefly, in Mr. Keynes' mind the alternatives to inflation were "iron" price control and rationing, or the withdrawal of purchasing power from the hands of the public. Mr. Keynes, as the whole world now knows, advocated the latter method, the withdrawal of purchasing power by means of forced savings. Voluntary savings would serve the purpose as well, he argued, but there was no way in sight by which they could be made large enough. In this argument Mr. Keynes failed, as others have failed, to see that unless the commodity side of the problem was put under control, price increases could not be forestalled.

At the end of the book, with his argument complete, Mr. Keynes held over the heads of his readers, as a kind of club, the system already in force in Germany: "A complete fixation of wages, hours and prices, a comprehensive system of rationing supplemented by shop shortages and prohibitions of every kind, and a series of deductions from wages . . . which add up to a formidable total several times heavier than the scale of deferred pay proposed above for the lower group of incomes."⁵ If such controls were installed in Great Britain, he believed, the war effort would be increased by fully 50 per cent and perhaps substantially more. But the German system in its entirety

⁴ John Maynard Keynes, *How to Pay for the War*, p. 8.

⁵ *Ibid.*, p. 75.

was that which the British wished to avoid, even as a temporary measure, by any means short of jeopardizing ultimate victory.

To summarize once more: Mr. Keynes believed that the rationing and price controls used in Germany would increase British wartime efficiency by more than 50 per cent, but the system was so obnoxious to the British mind that the less efficacious levies on wages were to be preferred. Even at the moment, however, when we in the United States were reading these words, Great Britain was in danger of losing the war. This was in the late spring of 1940, when the invasion of Norway and Denmark, the conquest of the Low Countries, the fall of France, and the disaster of Dunkerque, were already under way. Immediately the British and their government became less choosy about the methods they were willing to use to win the war. They utilized everything they saw as efficacious, whether or not it had ever been used by hostile governments. After another year had passed they used Mr. Keynes' plan, but they also used price controls and rationing. They developed extremely high income and profits taxes, but they now saw them as a part of a much larger system.

It is unlikely that we in the United States will contemplate higher federal income taxation than that adopted in the last British budget, that of April, 1941. This budget placed the standard rate of income tax at 10 shillings in the pound, or 50 per cent; set the maximum surtax rate at 19 shillings and 6 pence, or 97.5 per cent; and by lowering the exemptions and installing Mr. Keynes' device of compulsory saving in the lower income tax brackets, brought some 2,000,000 new income taxpayers into the orbit of the income tax.

TAXATION AT THE MAXIMUM

As a result of the 1941 budget, Great Britain now furnishes us with the best example we shall probably be able to have, among the countries organized politically along the same general lines as the United States, of the effective confiscation of purchasing power through the income tax. The British system so operates that the ceiling in incomes is now approximately \$16,000. *The Economist* of London analyzed the effect of the income tax at the different levels as follows:

To secure a net income of £2,000 [\$8,000] needs a gross income of rather over £4,000 [\$16,000] (the exact excess depending on the personal circumstances of the taxpayer); . . . A net income of £3,000 requires a gross income of about £9,000—there are less than 10,000 people who can reach this level. The next step, to a net income of £4,000, requires a gross income of £30,000, of which there are only about 1,000 [people]. . . . The rise to £150,000 gross contributes only £1,150 net. The upshot of these figures is that there is an effective limit to net income at about £4,000 [\$16,000] per annum; only a few hundred persons can penetrate above this limit and the highest net income in the country cannot be more than about £7,000 [\$28,000].⁶

Here, then, is the probable maximum use of income taxes and the withdrawal of purchasing power from the hands of the public. But prices have continued to rise. It should be remembered that Great Britain also has a maximum excess profits duty. The rate still stands at 100 per cent, although in the budget of 1941, modifications were made for such companies as those with diminishing assets, such as in mining. It was conceded that the 100 per cent rate acted as a serious deterrent to production—and goods produced in larger amounts would be, of course, a deterrent to inflation—particularly in discouraging efforts to keep

⁶ April 19, 1941, p. 518.

down costs, including wage costs. But in the opinion of the Chancellor of the Exchequer, Sir Kingsley Wood, the rate was "dictated by wider issues of policy than fiscal considerations."

In addition to these two high taxes, those on income and excess profits, the budget of April, 1941, included new taxes on low incomes in order to work out a plan very like that proposed by Mr. Keynes. The extra tax which any individual pays by reason of the reduction in personal allowances and the reduction in earned-income deductions, is to be offset after the war by a credit which will be given to the income taxpayer at the Post Office Savings Bank. In describing this part of the income tax, the Chancellor of the Exchequer expressed the point of view of those who believe that the income tax should be used as a part of an anti-inflation system. He said that the primary purpose of the tax increase was not to obtain taxation for the sake of revenue, but to obtain a cut in spending power during the war. The plan as it was adopted lacked some of the details proposed by Mr. Keynes, but the omissions do not affect the efficacy or lack of efficacy of the weapon. Mr. Keynes had advocated provisions for family allowances and for emergencies such as heavy medical expenses. The point here is that, in addition to the highest practicable maxima of income and excess profits taxes, the device of compulsory saving through the broadening of the income tax at the base is in use in Great Britain. And yet the hints of inflation remain, and price controls have had to be further tightened.

This was duly recognized even before the fact in the budget speech which contained the new measures; for Sir Kingsley Wood said, then, that there still remained in the budget a potentially dangerous "inflationary gap" of some

£500,000,000 which would soon be vitiated by a rise in prices; and that the money being spent in government subsidies to keep down food prices was "a most important development of policy." He further said that he was leaving a substantial margin in the estimates for subsidizing many products other than food, in order to hold the cost-of-living index number at its present range of 125 to 130 per cent in terms of the prewar level.

THE PATTERN OF CONTROLS

Food and other subsidies are, then, one more part of the system of anti-inflation barriers. The system also includes rationing, price control, materials control, and the direction of labor. The British Chancellor of the Exchequer has compared the controls to the building of a well-constricted dam. With respect to taxation's part, he said that "there must also be an abatement in the force of the torrent if success in avoiding inflation is to be achieved."

The President of the British Board of Trade has also taken a turn at describing the interrelation of the various parts of the system, beginning with the price control aspects:

It [price control legislation] has the general objective of assisting the diversion of production and productive capacity to war purposes, while at the same time keeping down the cost to the public of the necessities of life. . . . A further virtue of rationing is that it prevents the pressure of demand on a limited supply from pushing up prices. On the financial side, inflation is further avoided by a system of high taxation and the campaign for saving, which has the effect of immobilizing in the hands of the public the extra purchasing power which has been put into them as a result of the war. . . . All these measures are coordinated. . . . They are part of a general plan.⁷

⁷ "British Price Control Legislation," *Foreign Commerce Weekly*, September 27, 1941, p. 37.

But the general plan is a partial one, for British rationing and price control are still on what Prime Minister Mackenzie King of Canada would call a "commodity by commodity" basis. The change in the price level has been gradual in recent months, but the latest index numbers published in the *Federal Reserve Bulletin* show slow increases.

In conclusion, two comments are pertinent. One is British, the other American. The first is from the London *Economist*:

Inflation has been checked, not by the effective curtailment of "excess" incomes (by means of taxes—swingeing though these imposts have undoubtedly been—savings or restraints on wages and salaries), but by the control of consumption—by the restriction of supplies, by extended rationing and by a general disposition on the part of consumers to hang on to their money, to hold larger cash balances and not, on the whole, to scramble for scarce goods.⁸

The second is by the American income tax expert, Professor Roy G. Blakey:

There are those who seem to be enamored of the theory that tax controls can be substituted for monetary controls and thereby the whole economic regime can be made to do their bidding. . . . All of these regulatory, as well as fiscal possibilities, should be kept in mind and taken advantage of so far as possible without unduly harmful effects, but it takes a great deal of wisdom and skill to avoid disastrous results at the hands of would-be reformers and amateurs.⁹

⁸ September 13, 1941, p. 316.

⁹ Roy G. Blakey, "The Personal Income Tax and Defense," *The Annals of the American Academy of Political and Social Science*, CCXIV (March, 1941), 66.

CHAPTER VI

INCOME VERSUS SALES TAXATION AS AN ANTI-INFLATIONARY CONTROL

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TAXATION is an appropriate anti-inflationary control device in situations where the causes of inflation are due to governmental fiscal policies, or to threatened changes in the general price level arising from increasing individual purchasing power available for expenditure on decreasing quantities of goods. Where inflation is associated with government financing, the cause has usually been excessive borrowing via bank credits or paper money; or to state it another way, the inability of governments to finance current operations by taxation and borrowing from income. The escape by fiscal means from inflation so induced is by the balancing of budgets through retrenchment or increased taxation. This requires the reversal of fiscal policies responsible for the plight of the government. Inflation of such a type occurred in Germany, Austria, and France following World War I. It is not the kind of inflationary danger we face today.

INFLATION DUE TO MONETARY FACTORS

Where inflation is due to monetary factors, such as an influx of gold, the expansion of currency, or movements of foreign exchange, taxation may be specially directed at

* The writer is indebted to Messrs. Lloyd Mints, John K. Langum, and Henry S. Bloch for assistance in the preparation of this paper. They are not responsible for the views expressed.

such conditions. Where the danger of inflation from such causes is not great, banking controls, such as through open market operations, are the usual remedy. In any war emergency the danger of inflation through excess borrowing from commercial banks is always present. The policies followed by this nation in financing World War I were directly responsible for the price increases of that time. Not only did commercial banks subscribe heavily to successive issues of Liberty Bonds, Victory Notes, and short-term issues,¹ but they financed a substantial portion of individual subscriptions by means of deposit credits.² This is a story the lessons from which were so well learned as to need no repetition here. The Treasury, to date, has sought to avoid their recurrence, first, by increasing the amount of taxes relative to loans to be employed in financing present war activities,³ second, by attempting to borrow such funds as are needed in a non-inflationary manner⁴—that is, from current income.

¹ For example, United States government securities held by member banks in the Federal Reserve System were as follows:

(In Millions)												
1917	March	5	\$	700	1918	May	10	\$3,200	1919	March	4	\$4,700
	May	1		700		June	29	2,500		June	30	3,800
	June	20		1,100		Nov.	1	3,600		Nov.	17	3,500
	Dec.	31		1,800		Dec.	31	3,500		Dec.	31	3,300

Source: *Annual Report of United States Federal Reserve Board*, 1932, pp. 128-29.

² During World War I, banks loaned about three billion dollars on government securities. Cf. Hansen, "Defense Financing and Inflation Potentialities," *Review of Economic Statistics*, XXIII (February, 1941), p. 5, col. 2.

³ In World War I, funds to cover expenditures were raised one-third by taxation and two-thirds by loans. *Annual Report of The Secretary of Treasury . . . 1919*, pp. 25-26. In connection with defense financing, Secretary Morgenthau announced that the ratio should be two-thirds from taxation and one-third from loans; see *The New York Times*, April 18, 1941. The Secretary was of the opinion that this "would certainly be a strong deterrent to inflation." *Ibid.*

⁴ Defense savings bonds, Series E, F, and G, were designed for subscription by individual investors. Series E bonds are not transferable and are

ALL-OUT ATTACK ON INFLATION

The conditions leading to inflation created by war, or by equally intensive preparations for war or defense, call for a unified attack using all available instruments of control. It makes little sense to talk about monetary or credit controls as being the ones to use, or about fiscal policies as being the proper instruments, or about direct price controls, rationing, allocations, and priorities as being best adapted to check inflation, or about other single methods of attack. What is essential is an all-out attack on inflation with all available instruments. Since there must be some limitations of space on the compass of discussion, other measures than income and sales taxes will be excluded from consideration here.⁵ This exclusion, however, carries no implications of unimportance for the measures not discussed. It must be assumed, moreover, that the

payable only to named registered holders except in case of death or disability. They may be neither sold nor hypothecated, but are redeemable at discounted values prior to maturity, the discounts being arranged to foster holding until maturity. Individual subscriptions were limited to \$5,000 in any one year. Series F and G bonds were issued in registered form, were nontransferable, matured in twelve years, but were redeemable before maturity at fixed values (after six months from date of issue) on one month's written notice. Holdings of bonds of F and G Series were limited to \$50,000 during one calendar year. Subject to this limitation banks (other than commercial), corporations, and individuals could subscribe. Series F bonds were issued on a discount basis while Series G were income bonds. *United States Treasury Circulars*, Nos. 653 and 654, April 15, 1941.

⁵ Sales and income taxes are of various types; not all of them can be discussed. The sales taxes to be considered here are excises levied on specially selected commodities and a general sales tax, perhaps, with the exemption of some commodities such as food. As a device for controlling inflation, a retail sales tax is superior to a manufacturer's or a wholesaler's sales tax. It is imposed at the time of more final sales than would otherwise be the case; it decreases the extent of pyramiding and, therefore, has less effect upon prices; the levies would be more conspicuous and less concealed in final prices. The resistance to a retail sales tax might be greater than to other types of sales taxes, but this would tend to limit the duration of the tax to the emergency period. If administrative costs were higher, they would be worth it. States have effectively operated these

various alternative controls are used in complementary fashion. If, for example, inflationary borrowing should finally be resorted to—and the present volume of subscriptions by individuals makes loans from commercial banks a likely possibility⁶—it should not be assumed that heavier taxation would be the only control to be applied. This discussion will be less speculative if it may be assumed that non-inflationary borrowing and rigorous direct efforts at price control supplement tax policies aimed at preventing inflation. It is to be hoped that the national government will also attempt to control wage rates and other cost-raising factors. If these things are done, the chances for success in preventing inflation are greatly increased. If nothing is done about them, little can be expected of fiscal measures acting alone.

WAR CREATES INFLATIONARY CONDITIONS

It is inevitable that war or intensive rearmament should produce conditions favorable to inflation. The physical task of creating war material presupposes the conversion of industrial plants from the manufacture of civilian to the manufacture of military goods. The increase in the armed forces reduces the number of people available for the satisfaction of peacetime wants. These transfers continue (if

taxes for a considerable period and the federal government, just as in the case of income taxation twenty-five years ago, can learn much from their experience.

The income tax to be considered will be the usual net income tax, two features of which are exemptions and progressive rates. Payroll taxes will also be discussed. They are distinguished from personal income taxation by the absence of family deductions and exemptions.

⁶ For example, if comparisons are made for May through September for 1940 and 1941, it may be observed that income payments in the United States are increasing at a more rapid rate than subscriptions to defense savings bonds. The new tax bill has not yet affected the increased incomes, nor have the tax anticipation notes greatly reduced the funds available for current expenditure.

the war lasts long enough), until civilians are left with just enough goods and services to preserve morale and to maintain the efficiency of the population as a laboring force. Pressure to increase the supply of munitions draws into war industries continuously increasing amounts of labor,⁷ and usually at ever larger rates of pay. The result is that the population outside of the armed forces finds itself in possession of larger and larger amounts of income.⁸ If taxes are not raised sufficiently, such funds can be spent on a decreasing quantity of civilian goods.⁹ That is just what is happening today.

The budgetary aspect of war is also inflationary. The military arm of government when engaged in large-scale operations demands increasing amounts of materials to be purchased on government account. Little thought can be given to the cost of needed goods if victory is to be won. Whatever is necessary in the way of goods and materiel must be made available to the army and navy. If cash is lacking or taxes are inadequate, claims for goods must be met either from the proceeds of loans or from purchasing power otherwise created. There is a tendency, too, for obligations for materiel to accumulate prior to and in larger volume than taxes accrue. In general, neither tax legislation nor tax collections tend to be speeded up suf-

⁷ Much of the labor used in war industries is highly skilled and its withdrawal seriously handicaps peacetime production.

⁸ The index of factory payrolls has risen from 97.8 in May, 1940, to 163 in September, 1941. The average hours worked per week by wage earners in manufacturing industries rose from 37.2 in April, 1940, to 41.0 in August, 1941. Average hourly earnings in these industries rose from 66.5 cents per hour in April, 1940, to 74.5 cents in August, 1941. *Federal Reserve Bulletin*, July, 1941, pp. 676-77; November, 1941, pp. 1177-78.

⁹ The indices of producer's and consumer's durable goods, compiled by the Federal Reserve Bank of New York, have been growing farther apart since about March, 1940. Since August, 1941, there has been a marked decline in the index of production of consumer's durable goods. *Monthly Review of Credit and Business Conditions*, Federal Reserve Bank of New York, November 1, 1941, pp. 87-88.

ficiently to offset these current obligations, until decisions have been reached on battlefields. The government has no choice except to underwrite whatever scale of expenditures is required by military necessities. Demands for retrenchment play into the hands of the enemy. Failure to cover the expenditures by taxes tends to create inflationary pressures, which can be reduced only by continued increases in taxation and non-inflationary borrowing. Important as is the type of borrowing, it too must be excluded from this paper.

If price inflation is to be prevented, the surplus of earnings, above the cost of maintaining the labor supply (civilians) in a state of efficiency and contentment, must be kept from bidding up the price of the dwindling supply of consumers' goods. This reduction of income available for consumption can be accomplished, (1) by voluntary hoards to be held for the duration of the emergency; (2) by direct investment in nonnegotiable securities to be held "for the duration"; (3) by taking, through taxation, income above living costs. Investments in nonnegotiable bonds deprive individuals of funds until such time as bonds are paid or redeemed. Taxes take personal resources and permanently transfer them to the use of government. As government expenditures take place, these funds flow back into personal income streams and the process of income-sterilization must commence anew.¹⁰

¹⁰ Firm resolutions not to spend, *if carried out*, keep individual resources out of the market place and do not affect prices, but the idle resources are of no service to the government in financing defense if the hoards are outside of financial institutions. True hoards, nevertheless, are not inflationary. From the point of view of controlling inflation, the larger they are the more effective the damper. At the present time hoards are not a practical problem. Undoubtedly, if hoards were accumulated in substantial amount, patriotic and other reasons would probably compel the government to adopt forced loans, capital levies, or increased taxation in some other form.

On the production or physical side, the increase in goods for civilian consumption may keep pace with, or even keep ahead of increases in civilian purchasing power in the early stages of the war effort. In the first place, the transfer from a peacetime to a wartime economy takes time. Not all industries can be transformed at once. While a gradual transition is being made, the production of goods for civilian requirements can continue. Likewise, if the rearmament program finds the country with unemployment and unused productive facilities, these can be absorbed before production for nonmilitary use needs to be curtailed. This is the basis for "guns and butter" in the recent discussions.¹¹ The danger, of course, is that butter will continue to be churned long after the manufacture of guns should have been multiplied. It is folly, in a military sense, to argue for the continued production of civilian goods. The greater the quantity of such goods to be exchanged for the growing salaries and wages, the less will be the price rises and the danger of inflation. The more remote also will be the military victory and the smaller the quantity of guns, munitions, and battleships in the hands of those who need them.

CONSUMPTION CONTROL VIA EXCISE TAXES

It may be argued that the sale of goods to civilians can be reduced by artificially raising prices by means of taxation. This doctrine rests upon the assumption that, as a result of price increases, consumers will purchase in decreasing quantity those goods for which demand is elastic. To the extent that such facts exist, excise taxes may be employed to reduce the consumption of certain goods, but the tax increases and price changes resulting, probably have

¹¹ Cf. Bloch, Lange, Harbison and Lewis, *Economic Mobilization*, p. 12.

to be unconscionably large, and the goods to which the taxes can be applied may not be as numerous as is commonly supposed.

If excises are to reduce consumption, those goods with relatively inelastic demands must be excluded. Tax policy and tax rates will have little effect upon their consumption unless the rates are practically prohibitory. The cardinal folly of sumptuary taxation has been the selection of goods, the demand for which is highly inelastic. The list includes tobacco, liquor, cosmetics, gambling devices, and playing cards. Moderate changes in price have little effect on their consumption. It is not accidental, therefore, that the most productive of the federal excises are on liquor and tobacco.¹² The consumption of gasoline, to which the sumptuary principle has not been applied, is also little affected by price changes. It is no doubt true that *great increases in price* accomplished through excises could affect the consumption of these goods, but such a policy would interfere with the revenue yield of the most productive of the federal excises. It is doubtful if the reduction

¹² The importance of these excises may be indicated as follows:

Year	Total Tax Revenues	Total Excise Taxes	Excise on Tobacco		Excise on Liquor	
			Amount	Per cent Total (Col. 2)	Amount	Per cent Total (Col. 2)
1917	\$1,118,174,126	\$ 392,188,000	\$102,577,000	9.2	\$284,009,000	25.4
1939	5,910,778,701	1,707,000,000	580,159,000	9.8	587,800,000	9.9
1940	6,154,073,297	1,851,103,000	608,072,000	9.9	624,064,000	10.2

Source: These compilations are based on *Annual Reports of the Secretary of the Treasury*, 1918, pp. 976-77; 1940, pp. 644, 696-97.

"Total Tax Revenues" is defined as all federal taxation including tariffs.

"Total Excise Taxes" include only taxes levied on specific commodities.

in the sale of tobacco, liquor, or even gasoline (the aviation brand excepted) would contribute as much to the war effort as the fixing of the revenue at the point of maximum return.¹³

From the standpoint of inflation control, it is not enough to affect the price of the taxed goods. Inroads must be made into the aggregate of funds available for expenditure, so that individuals will have less to spend than before. Excise taxes may also be used to change the direction of spending from goods relatively scarce to those more abundant (or even available in almost unlimited quantities). If individuals are made poorer because they buy goods to which excises have been attached, the incidence of such taxation is upon them. The fact that they are poorer may also change the quantity and quality of other purchases. At any rate, they will have less money with which to buy other goods or bid for them. The danger of inflation is thereby lessened. Excises on goods with elastic demands tend to change the direction of spending as individuals seek to avoid paying increased prices for goods—in short, to *avoid* the burden of consumption excises. The government, therefore, can so select its excises as to direct consumption away from the goods needed for the war effort, and into those channels where increased demands will neither tend to raise general prices nor develop shortages in materials. This change in the direction of consumption seems to be possible wherever demand schedules are relatively elastic—that is for most things—but the doses of taxation required may be quite large. And if the plan worked, the revenue from the excises so employed would not be large. The more successful the diversions of

¹³ It is believed that if consumption were to be reduced, the revenue to the government would be reduced as well.

consumption to untaxed fields (or to those less taxed), the smaller would be the revenue produced. Congress would have to depart from its idea of excises for revenue, and use excises to implement consumption controls. This is more important than the negligible revenues received from excises other than on liquor and tobacco.¹⁴ There is little reason, however, to change the revenue policy on these two commodities. In other fields, the policy of consumption control would require the development of very different schedules for excise taxation. They could be developed in conjunction with priorities. Those goods which were scarce and urgently needed for defense, such as copper, manganese, tin, steel, etc., with their final products, could be heavily taxed to the consumer and their use discouraged. New automobiles, radios, refrigerators, building materials, and electrical appliances would certainly be singled out for substantial excises, while theatres, night clubs, bowling alleys, similar diversions, and educational activities requiring few critical materials, could be made relatively and absolutely more attractive. The more money spent on the latter class of "goods," the less are the inflationary dangers.¹⁵

If an adequate brake for inflation is to be developed, the direct reduction of individual resources available for expenditure is far more promising than their eventual reduction through excises collected at the time of expenditure. In short, income or general sales taxes seem to be far better as anti-inflationary measures than special sales taxes, con-

¹⁴ In 1940, 42.7 per cent of tax revenues of the federal government were derived from excises. Tobacco and liquor excises equalled 27.4 per cent of tax revenues, other internal revenue stamps provided 9.9 per cent, while the manufacturers' excise accounted for 4.5 per cent. *Annual Report of the Secretary of the Treasury . . . 1940*, p. 696-97.

¹⁵ A natural consequence of directing consumption from scarce to more abundant goods is the decrease in the pressure for inflation.

sumption taxes, or excises, by whatever name they may be called. But what is the choice between them?

AFFECTING CONSUMPTION THROUGH INCOME TAXATION

If a net income tax is to affect consumption appreciably, it must reach down into the brackets in which the bulk of consumption takes place. Incomes above the personal exemptions must be so reduced as to leave substantially smaller aggregates available for expenditure. Inasmuch as over 97 per cent of the consumer units receive incomes of less than \$5,000 per annum, this is the group toward which anti-inflationary taxation must be directed. This group also accounts for 88 per cent of consumption expenditures measured in dollars.¹⁶ In 1936, a year which corresponds with the time these consumption statistics were compiled, only 4.22 per cent of the population of the nation filed federal income tax returns, and only 2.23 per cent of the population were subject to this tax.¹⁷ In that year, the total revenue receipts of the federal government, including postal revenues, were only 12.1 per cent of the consumption expenditures of families and single individual units.¹⁸ In 1938 the total taxes of federal, state, and local governments were estimated to take 20 per cent of total consumer incomes in that year.¹⁹ Federal taxes took but 9.2 per cent.²⁰ When these data are distributed by income brackets, it ap-

¹⁶ *Consumer Expenditures in the United States: Estimates for 1935-36*. National Resources Committee, p. 4.

¹⁷ In 1936 the total number of returns filed was 5,413,499; the number of taxable returns was 2,861,108. Population estimate for that year was 128,237,965. For comparisons for years 1916-39 see Leland, "Defense Financing and Monetary Problems," *Hoosier Banker*, June, 1941, pp. 26-28, 50-57.

¹⁸ Total revenue receipts were \$4,781,299,971. *Annual Report of the Secretary of the Treasury . . . 1940*, p. 645. Aggregate consumption was \$39,458,000,000. *Consumer Expenditures in the United States, 1935-36*, p. 48.

¹⁹ G. Colm and H. Tarasov, *Who Pays the Taxes?* Monograph No. 3, Temporary National Economic Committee, p. 6.

²⁰ *Ibid.*

pears that approximately 80 per cent of consumer incomes for 1938-39 are found in the income classes of \$5,000 and less, yet these income classes paid 69 per cent of the total tax bill (federal, state, and local).²¹ Although their tax bills are heavy, their consumption must be affected if inflation is to be checked. This cannot be done if federal taxes are limited to a small proportion of the nation's population and to a fifth of consumer income.

The 1941 tax bill has been amended to bring within its scope an increasing number of taxpayers. Exemptions have been reduced to the lowest level in our history—to \$1,500 for married persons and heads of families, and to \$750 for single persons. This change is expected to raise the number of returns from 15,160,000 filed this year to 22,108,000. The total number of taxpayers, individual and corporate, is expected to rise from 8,000,000 to 13,200,000.²² The new income and excess profits taxes are expected to produce about twice as much revenue in 1942 as was produced in 1941.²³ From the standpoint of consumption control, this is not enough. Too large a fraction of consumer income is either not taxed at all or else not severely enough, and the income tax is too slow in reaching the increased incomes from which taxes are paid.²⁴ The lag between income earned and income tax payments is at least one year (measured from the midpoint of the year of earnings

²¹ *Ibid.*, p. 28.

²² *The New York Times*, October 27, 1941.

²³ These taxes produced \$3,470,000,000 in the fiscal year which ended June 30, 1941, and are expected to produce \$7,079,000,000 in fiscal 1942. *Ibid.*

²⁴ There is reason to believe that the practice of setting aside reserves out of current income for the payment of taxes is not general. The practice is confined largely to firms, corporations, and wealthy persons. The lower the exemptions the greater will be the number of those who do not set aside tax reserves out of current income. Data are not available to confirm this hypothesis. It is doubtful if tax payment reserves affect the bulk of United States consumption.

and the year of payments). To shorten this gap, the Treasury has introduced tax anticipation notes. But the sale of these notes, like the sale of defense bonds, is proceeding at a slower rate than incomes are increasing. From May through October, 1941, the sale of defense bonds amounted to \$1,775,000,000. Tax anticipation notes sold from August through October, 1941, amounted to \$1,818,000,000.²⁵ During the months of May, June, July, and August, 1941, money payments in the United States were \$4,808,000,000 more than in the corresponding months of 1940. Salaries and wages rose over \$3,875,000,000 in these four months of 1941 over 1940. The national income rose from an annual rate of \$90,000,000,000 in August to \$92,000,000,000 in September, yet during September only \$232,000,000 in defense bonds were sold, while subscriptions to tax anticipation notes aggregated \$306,000,000, of which only \$8,000,000 were of the Series A variety designed for smaller taxpayers.²⁶ Voluntary subscriptions to defense loans, plus

²⁵ *Federal Reserve Bulletin*, November, 1941, p. 1081.

²⁶ SALES OF DEFENSE SAVINGS BONDS AND TAX NOTES
MAY-OCTOBER 1941
(Issue price. In Millions)

Defense Savings Bonds				Tax Anticipation Notes		
	Total	Series E	Series F and G	Total	Series A	Series B
May.....	\$ 350	\$101	\$ 249	\$...	\$...	\$...
June.....	315	103	212	...	...	...
July.....	342	145	197	...	...	...
August.....	266	118	148	1,037	18	1,019
September.....	232	105	127	306	8	298
October.....	271	123	148	475	7	468
Total.....	\$1,776	\$695	\$1,081	\$1,818	\$ 33	\$1,785

Source: *Federal Reserve Bulletin*, November, 1941, p. 1081.

the sale of tax anticipation notes, are not taking place in sufficient volume to remove the danger of inflation. Likewise, loan subscriptions are being financed largely from idle bank balances—which is inflationary in high degree. Additional controls should, therefore, be attempted.

Further inroads must be made into incomes as they are being received, in order to decrease the amount available for subsequent expenditure. This calls for installment payments at least monthly, or the withholding at the source of a certain percentage of all income payments, or the collection of taxes based on expenditures as income is in fact spent. In short, the alternative is the current collection of income taxes or the imposition of an emergency sales tax.

MORE FREQUENT COLLECTIONS

If income taxes are collected monthly, the increased payments under the 1941 law can be paid more conveniently by most taxpayers. In spite of the administrative inconvenience and increased cost of collection to the Treasury, under the increased schedules now in force, a change of policy in this direction is in order. True, taxes on 1941 incomes would not be payable monthly until 1942, and on 1942 incomes, until 1943. What is really needed is payment from incomes as earned, taxes on 1942 incomes payable from incomes during 1942. If this were done, taxpayers might have to pay two years' taxes in one, but an effective move against inflation would thereby be made. Individuals would be paying during 1942, taxes on incomes earned in 1941, taxable under the 1941 act, and taxes on a monthly basis on 1942 incomes (under an act yet to be passed) as the income of 1942 was being earned. This was

the essence of Secretary Morgenthau's proposal, tentatively and informally ventured to the House Ways and Means Committee a few weeks ago.

INCREASE AGGREGATE TAX

It is not enough simply to increase the frequency of income tax collections. The aggregate tax bill will have to be increased greatly if the income tax is to be an effective curb on inflation. In 1939 the national income was \$70,-674,000,000, out of which \$14,090,000,000 (or 19.94 per cent) was paid in federal, state, and local taxes, inclusive of social security taxes. In 1940 the national income was \$76,035,000,000, and the total tax collections were \$14,562,-000,000. The national income increased by \$5,361,000,000; the total tax bill increased only \$472,000,000.²⁷ On the assumption that the national income for 1941 will be \$90,-000,000,000, a \$14,000,000,000 increase in national income will compare with a tax bill probably increased by not more than \$5,000,000,000.²⁸ If the subscriptions to defense bonds and tax notes are doubled to allow for additional purchases during the remaining two months of this year,²⁹ approximately \$2,000,000,000 of the increase remains unaccounted for. If the national income achieves the annual rate of \$92,000,000,000 on the basis of September data, two additional billions will be added to the inflationary pressure. On the other hand, there are probably some slight offsets as well as increases in consumer's goods to be taken into account.

²⁷ Tax Institute, *Tax Yields: 1940*, p. 25.

²⁸ It was assumed that 1940 tax collections would increase by 10 per cent, and to this sum was added \$3,553,400,000, the additional revenues estimated under the Revenue Act of 1941. For the latter see *Federal Reserve Bulletin*, November, 1941, p. 1079.

²⁹ Cf. data previously given. Total is \$7,186,000,000.

REDUCE EXEMPTION OF MARRIED COUPLES

If income taxes are to be increased (and they should be), where shall the increases be made? If equality of treatment is to be provided between married couples and single persons, the exemption for married persons should be reduced from \$1,500 to something between \$1,000 and \$1,250.³⁰ The federal income tax exemption for single persons is \$750. The differential is greater than costs of family living justify. It is worth mentioning, too, that the intolerable inequality of treatment between community-of-property states and others, with reference to joint returns for husband and wife, should be removed.³¹ Income is really family income anyway in all but exceptional cases, hence all returns between husband and wife should be joint. This alone will add \$323,000,000 to the tax revenues of the government.³² It is worth, as an anti-inflationary control, more than the average monthly sale of defense savings bonds to date. Decreases in exemptions will be worth even more.

INCREASED RATES

It is undoubtedly true that tax rates can be increased somewhat even in the lower brackets, if taxpayers are will-

³⁰ Single persons in the income bracket \$750-\$1,000 have negative savings of 0.5 per cent of income. Families in the \$1,250-\$1,500 income level save on the average 1.0 per cent of their incomes; those in the \$1,500-\$1,750 income level save 3.5 per cent of their incomes. Negative savings for families do not begin until income levels drop below \$1,250. In the \$1,000-\$1,250 bracket, negative savings equal 2.8 per cent of income. If these data were used in fixing exemption limits, the exemption would fall in the \$1,000-\$1,250 income class if single and married persons were to be treated more on a par. *Consumer Expenditures in the United States, 1935-36*, pp. 20, 32.

³¹ Cf. Secretary Morgenthau's statement before Senate Finance Committee. *The New York Times*, August 9, 1941.

³² Cf. *The New York Times*, July 3, 8, 20, 1941.

ing to make further sacrifices for defense. For single persons earning \$1,000 the 1941 rates take less than 50 cents per week. If they earn but \$800, they can spread the \$3 tax bill over an entire year. Married couples with one dependent and \$2,000 of income are taxed at the rate of about 12 cents per week. Taxes payable under the 1941 act for other situations and earnings up to \$10,000 are shown in Table 1. Purely nominal payments are the lot of too many individuals and families in the United States (irrespective of war or peace).

From a fiscal point of view lower, upper, and middle bracket rates can all be increased, if Congress is willing to do it. It could, with much favorable urging from scholars, adopt the Hobsonian principle of taxing surplus incomes³³ and fix a ceiling on earnings after the current British pattern.³⁴ It is extremely doubtful, however, if that would be as effective a brake on inflation as lowering exemptions further, particularly for the married, and increasing the lower and middle rates. One-third of the families and individual consumer units have incomes under \$780. Approximately 10 per cent of consumer income is in that income group. The middle third of the families—those in the \$780 to \$1,450 income class—have about 24 per cent of the aggregate incomes. Two-thirds of consumer income is above \$1,450. Almost 85 per cent of family income is above the \$1,000 income level; two-thirds of family income is above \$1,500; about 83 per cent of the income of single individuals is above \$750. Sixty per cent of consumption expenditures are made by those having incomes of \$2,000 and under; 78 per cent by those with

³³ J. A. Hobson, *Taxation in the New State*, Chaps. II, IV, V.

³⁴ Cf. Chapters V and XV for summary of British taxes.

incomes of \$3,000 and under.³⁵ Exemptions below \$750 for single persons, and \$1,000 to \$1,250 for married couples, would trench more heavily on already inadequate stand-

TABLE 1
TAXES PAYABLE UNDER 1941 REVENUE ACT

Income Classes	Single Persons with No Dependents	Married Couples Living With Husband and Wife			
		No Dependents	One Dependent	Two Dependents	Three Dependents
\$ 750	...	...	...	...	...
800	\$ 3	...	...	...	...
900	11	...	...	...	...
1,000	21	...	...	...	...
1,100	31	...	...	...	...
1,200	40	...	...	...	...
1,300	50	...	...	...	...
1,400	59	...	...	...	...
1,500	69	...	...	...	...
2,000	117	\$ 42	\$ 6	...	...
2,500	165	90	50	\$ 12	...
3,000	221	138	98	58	\$ 18
3,500	284	186	146	106	66
4,000	347	249	197	154	114
5,000	483	375	323	271	219
6,000	649	521	453	397	345
7,000	825	687	619	551	483
8,000	1,031	873	789	717	649
9,000	1,247	1,079	995	911	827
10,000	1,493	1,305	1,205	1,117	1,033

Source: *Know Your Taxes*, United States Treasury Circular.

ards of living than is desirable, or politically feasible. But federal income taxes should begin at those levels. There is danger, however, that if burdens on the lower income groups are too quickly and too drastically increased, large tax delinquency may result. The income tax as a

³⁵ Data taken from *Consumer Expenditures in the United States, 1935-36*, especially p. 77.

sound tax measure might become discredited as evasion and avoidance increased. Whatever is done really needs the support of public sentiment.

There can be no question, however, from a theoretical point of view, but that personal taxation in support of government should begin at income levels just above actual subsistence costs. Some writers are even willing to argue in favor of universal taxation without regard to the minimum of subsistence, cases of hardship being met through abatements or a program of social welfare expenditures. Either of these approaches seems to require coordination with state and local tax programs, if individual tax burdens are to be fairly adjusted. That low-level income taxes can be effectively administered is indicated by the experience of many states. Too much weight, therefore, should not be given to the administrative objections to lower federal exemptions.

INCREASE PAYROLL TAXES

Another approach to the problem would be to increase payroll taxes. Salaries and wages have already risen to record heights, primarily as a direct result of defense activities. The lot of the wage earner has greatly improved. His pay envelope contains more dollars; he is ready to spend and has been spending his earnings. A payroll tax increase, deducted regularly at the source, would operate as an inflationary curb, but presumably it would affect only those now covered by the social security program. There are many who believe that these taxes could be increased without causing labor to demand increased wage rates. There are others who think that labor is only in-

terested in what is in the pay envelope, and, therefore, increased payroll taxes would tend to push up costs and thus give added impetus to the inflationary cycle. Some believe that such strikes could be avoided if the benefits of social security were extended. No doubt the increased coverage would soften the resistance of labor to inroads upon earnings.

Payroll taxes can be appropriately adapted to a cyclical or flexible fiscal policy—a thing which the nation sorely needs. Payroll taxes can be increased easily during periods of prosperity, provided they do not push up costs in situations like the present. They can be reduced, too, during depressions. We are already aware of some of the consequences flowing from their adoption and increase at such times. The ease with which added payroll taxes could be collected, as well as their immediate impact on current incomes, makes them appropriate instruments for dealing with inflation. Their reduction, along with the reduction of certain other taxes, can help solve some of the problems of depressions. Likewise, their reduction in the postdefense period might be made conditional upon records for continued employment. Their outright reduction might become a stimulus to continued business activity. The main shortcoming of payroll taxes is their present limited coverage. This, however, can be easily cured.

GROSS INCOME TAX ALTERNATIVE

A case could also be made for the adoption of a gross income tax without exemptions, as an anti-inflationary device. It would reach all income, or all above any fixed exemption. In the lower brackets it would differ but little from either payroll or sales taxes. It would be more diffi-

cult of administration than the payroll tax, although the present machinery for collecting social security taxes could be extended to it. Monthly collections would create no problems not present already in aggravated form. Nevertheless, it would be far less convenient of payment for those with small incomes than a sales tax. The effects seem so little different that a sales tax might even be superior.

SALES TAX APPROACH

There are many features about a sales tax which make it peculiarly useful under present conditions as an anti-inflationary control. It garners funds for public treasuries immediately after it goes into effect. There is no lag for individuals between the time tax liability accrues and payments are made. As soon as a retail sales tax, for example, becomes effective, consumers start contributing to the cost of government. The only lags involved are (1) the time between the receipt and spending of income, and (2) the time between the transaction on which the tax is collected and the date on which retailers remit to the state.³⁶ So far as consumers are concerned, the lag is shorter, on the whole, than even a monthly-collected income tax. A payroll tax or an income tax withheld at the source would, of course, have quicker effects, for under them taxes would be taken out even before income payments were made. This, however, is not true at the moment.

In times past the possibility of quick collections, as well

³⁶ This lag is for the convenience of business men who act as collection agents for the state. Obviously they could not remit the tax on each transaction. Daily or even weekly remittances would be burdensome. Until remitted, the taxes collected may serve as working capital for those who collect from consumers. The more frequent the remittances to the state, the more restricted is the temporary use of these funds.

as the regular flow of funds into their treasuries, has been of advantage to many states. Monthly collections of revenue have decreased the necessity for short-term loans made in anticipation of tax collections. During the depression, sales taxes thus relieved several states from temporary financial embarrassments. If inflation should come, the quick collection of sales taxes would again be advantageous. As prices increased, the yield from ad valorem sales taxes would automatically increase. The government would have additional funds from which to meet its added costs. The more violent the inflation, the more advantageous this would be, and the quicker the Treasury would feel the effect of increases in tax rates, should any be adopted. Professor Viner has fittingly called attention to this in connection with French and German postwar inflation: ³⁷

The Germans had the inflation under control twice during its course; then some unexpected political event (as the sudden demand for big reparations payments) broke the grip of the few men who were keeping their hands on the situation. Ignoring these two short periods when what was otherwise wild inflation was gotten temporarily under control, why did the German inflation go wild? A large body of opinion in Germany did not care what happened. They were in a state of despair as to the future of Germany, particularly under the Treaty of Versailles, and did not much care if the currency went to pieces if it brought an end to reparations payments. More important, the government budget was not in strong shape, the taxation system was not such as to produce an increase of revenue promptly upon any increase in price levels, and the government, without adequate credit to meet temporary deficits by borrowing, found itself repeatedly forced to meet current expenses by resort to the printing press.

The French inflation started in the same way—because of a government deficit which in the opinion of ministers of finance could not be met without resort to the printing press, but the French got it under

³⁷ Jacob Viner, "Inflation as a Possible Remedy for the Depression," *Proceedings of Institute of Public Affairs*, University of Georgia, 1933, pp. 124-25.

control. The differences between the two situations were, first, that nobody in France wanted the franc to go to pieces, and, secondly, the French budgetary system, and especially its revenue system, was such that inflation did not throw it out of gear as badly as in Germany. The German tax system was more like ours—it consisted primarily of direct, income, and inheritance taxes, levied on the values of one year, but not collected until the following year. So there was in Germany a lag of a year on the average between the occurrence of an economic event which created a basis for the levy of a tax and the actual collection of the tax. A year during a rapid inflation is a long period, and during a part of the German inflation a doubling or even a tripling of the rates of income tax each month would still not have sufficed to make income tax revenue keep pace with incomes measured in current marks. France on the other hand, relies largely on indirect taxes on gross receipts or on sales collected shortly after the receipts and sales occur. As inflation increased prices in France it also brought an almost simultaneous increase in tax revenues, so that the budget never got as seriously out of hand as in Germany.

It may be questioned whether sales taxes are a good deterrent to booms or to inflation. During the depression, sales taxes were criticized for their unfavorable effect on business, and were assiduously avoided by the federal government. The point has often been made that sales taxes tend to reduce the sale of goods the demand for which is elastic. A boom or the eve of inflation is a good time to produce these very effects. Any measure which will build up sales resistance and reduce consumer demand operates in the proper direction, unless the enhancement of prices through sales taxation adds impetus to the demand for higher wages to meet higher costs of living. Already, strikes in anticipation of increases in living costs have occurred. If sales taxes should add fuel to this fire, resort to them could well be questioned. The authorities may not be agreed as to just how labor would react to them. So far, there is little evidence on the point, but it seems reasonable to believe that labor attitudes would be less

favorable to sales taxes than to additional payroll taxes related directly to expanded social security benefits. The payroll taxes are regarded by many as insurance premiums or benefit payments, but it is probably too soon to decide whether labor will attempt to pass them on. Psychological attitudes toward taxation thus make difficult the choice between tax measures.

UNIVERSALITY, REGRESSION, AND INFLATION

The coverage of sales taxes is undoubtedly greater than that of income taxes. The sales tax reaches those below exemption limits, as well as groups not effectively reached by present income taxes. Conspicuous among those outside the reach of American income taxes are farmers and others whose income in kind cannot be taxed effectively. They can hardly escape a sales tax unless it is so designed. If it is not practical further to reduce income tax exemptions,³⁸ a sales tax may provide the desired universality of payments.

By way of illustration, a two per cent sales tax on mainly tangible property would collect from families under the \$500 income level, \$7.04 per annum; would collect on the consumption of those in the \$500 to \$750 bracket about \$10.86; and \$13.92 from those families in the \$750 to \$1,000 income class.³⁹ The bulk of these tax payments would be

³⁸ "Practicality" is a political rather than an economic judgment. It is the surmise of the writer, however, that Congress will not, in the near future, be willing either to reduce income tax exemptions to the levels suggested in this manuscript, or to raise rates in the low brackets to the height required to check inflation. "Too little and too late" is almost a maxim of current fiscal performance.

³⁹ These estimates were derived by applying the two per cent tax to average expenditures per family for the income levels indicated on food, household operation, clothing, automobile, medical care, furnishings, tobacco, and "other items." Expenditures excluded were for housing, recreation, personal care, transportation other than by auto, reading, and education. *Consumer Expenditures in the United States, 1935-36*, p. 23.

derived by taxing food;⁴⁰ the whole tax bill would come from taxing basic necessities. This is far from comforting. Moreover, the lower one-third of our families and single individuals had incomes in 1935-36 of less than \$780 and their consumption expenditures exceeded their incomes by 17 per cent.⁴¹ The middle third of American consumers with incomes between \$780 and \$1,450 also had budgetary deficits (—1.8 per cent), and spent 98.1 per cent of their incomes on current consumption. When the underfed, the poorly clothed, and the improperly sheltered are taken into account, the outcry against regression in sales taxation takes on real meaning. It is revolting to advocate such taxation when living standards for the masses are so low. The consequences of regression can, of course, be mini-

⁴⁰PERCENTAGE OF INCOME SPENT ON FOOD: 1935-36

Income Level	Families	Single Individuals
Under \$500.....	65.0	60.9
\$500-\$750.....	49.5	45.5
\$750-\$1,000.....	43.5	40.9
\$1,000-\$1,250.....	38.7	37.1
\$1,250-\$1,500.....	35.7	34.1
\$1,500-\$1,750.....	32.7	31.6
\$1,750-\$2,000.....	30.5	29.6
\$2,000-\$2,500.....	27.8	27.0
\$2,500-\$3,000.....	25.4	24.9
\$3,000-\$4,000.....	22.7	22.2
\$4,000-\$5,000.....	19.4	18.9
\$5,000-\$10,000.....	15.1	14.7
\$10,000-\$15,000.....	10.7	10.4
\$15,000-\$20,000.....	10.3	9.9
\$20,000 and over.....	5.4	5.3
All Levels.....	28.8	28.5

Source: *Consumer Expenditures in the United States, 1935-36*, pp. 78, 84.

⁴¹ *Ibid.*, pp. 5, 77.

mized by the exemption of food and clothing—materials also not now scarce. Income taxes, on the other hand, only reach those above whatever exemption is selected.

Nevertheless, inflation cannot be controlled effectively unless consumption is affected. To affect consumption by taxes necessitates resort either to regressive sales taxation, or to increased income taxation through the reduction of exemptions to subsistence levels and the increase in progressive rates. The effects are determined by the amounts taken from the respective income classes. Scholars differ in their opinions with respect to the amounts to be taken from various income levels. If equivalent sums are to be taken from the same income classes, the convenience of sales taxation to consumers and their immediate effect on consumption must be noted. If income taxes are withheld at the source, these gains of sales taxation are illusory. It is a question, then, of the groups affected by the tax measure selected. In the case of sales taxation, the groups are not usually identical. There is, in addition, the possibility of shifting to consumers more than the amount of the tax. Although the consequences of regressive taxation are harsh, they are as nothing compared with the burdens indiscriminately scattered by inflation. Income taxation beginning above subsistence levels will help prevent both hardships.

Perhaps the greatest risk in connection with the adoption of a sales tax as an inflationary curb, is the possibility that such taxes would continue to be a permanent feature of the federal tax system after the need for them had passed. Sales taxes have a large following of enthusiastic advocates who would like nothing better. Some favor the sales tax for its universality, others hopefully desire to substitute it for a significant portion of the income tax progressions. As a permanent adjunct of the federal tax

system, a sales tax would be undesirable beyond any doubt. As a tax restricted to booms and times of inflation, there is a place for it in the tax system. If the nation has the skill and courage to check inflation, it would probably be able to restrict sales taxes to appropriate cyclical periods. The risk that this may not be possible is always present, however.

CONCLUSION

In conclusion it may be stated that the choice between sales and income taxation as anti-inflationary controls is not unequivocal. Dogmatic pronouncements are imprudent. The essential problem of reduction of consumer's purchasing power can be accomplished either through income or sales taxation. It is largely a matter of personal opinion as to the course of action most appropriate to the situation. The answer depends, in the main, on attitudes toward regression in taxation, and the degree to which regression can be tolerated. In the interest of minimizing regression and yet to secure effective inflationary controls the following opinions are expressed:

1. Excise taxes for revenue should be restricted largely to tobacco and liquor.
2. Other federal excises should be directed at the problem of consumption control, with rates fixed as high as necessary to achieve the desired results. The commodities selected for excise taxation should be those essential to defense, the selection being coordinated with the establishment of priorities.
3. As a means of reducing consumer purchasing power, income taxes should be increased all along the line, but with primary emphasis on the lower and middle brackets. Later, if war continues to demand greater sacrifice, the doctrines of Hobson and Edgeworth may be applied to upper income classes after the present British pattern. Exemptions for married couples should be reduced at once; joint returns should become compulsory for husband and wife.

Monthly collections and check-offs should be instituted even if taxes for two years have to be collected in one.

4. Payroll taxes should be increased and the coverage of social security benefits should be extended.

5. If these steps are not taken (for political or practical reasons) to stop inflation, then an emergency sales tax should be adopted to fill the gap. (My preference is for a retail rather than a manufacturer's sales tax even though it would be more difficult and more costly to administer.)

Finally, when the possibilities of increased taxation are exhausted, the other alternatives—forced loans, deferred wages, and the like—may be considered. But funds for war, for defense, and for inflation control, should be raised by taxation in ever increasing proportions and amounts.

CHAPTER VII

A TAX ON GROSS INCOME PAYMENTS TO INDIVIDUALS

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THE PARTICULAR point of view from which various taxation proposals are to be discussed in this symposium is that of their effect upon the inflationary tendencies which inevitably emerge during a war. My assignment is to discuss a method of taxation which I have long admired, and which I proposed a year ago as the most effective means of transferring ready cash from the pockets of all the taxpayers into the Treasury.¹ In this paper the possibilities of a tax on the gross incomes of individuals will be considered, first, as a method of defense financing, and second, as a fiscal measure for the postdefense era.

It is unnecessary to engage in hair-splitting definitions of inflation. For all practical purposes the popular notion of it is sufficient, namely, that it is a substantial and fairly rapid rise of prices above the prevailing or customary level. There is increasing, but much belated, concern today about such a rise. One of the tests of competence in public officials is their capacity to perceive and understand the long-range effects of the policies which they are applying day by day. There have been many *recent* evidences of official

¹ H. L. Lutz, "A Tax to Meet Defense Needs," *Barron's Weekly*, XXI (January 6, 1941), 7; National Economy League, *Financing the Defense Program*.

awareness of the inflation problem, but it should have been apparent long ago to anyone who had any understanding whatever of the economics of war that an inflation problem was certain to arise. It should have been equally apparent long ago that the best time to forestall disastrous price increases was before the forces which produce these increases had developed strong momentum.

Since a substantial portion of the goods which the American people are now being paid to produce must be diverted from the channels of civilian consumption, it follows that they will be in possession of more income—i.e., purchasing power—than will be needed to acquire that part of their product which is to be available to them. They will possess more purchasing power, collectively, than they can use in buying the available goods except by paying more for each unit of goods. In other words, total current income and total currently available consumer goods can be equated only through higher prices.

Thus we have Act I, Scene 1, of the inflation tragedy. The rising prices lead to demands for wage increases, and the wage increases contribute to still higher prices. The climax and catastrophe of this tragedy are familiar to all.

The suggestion which I made a year ago, that there be imposed at once a substantial tax on all income payments to individuals, might not have sufficed to put the defense program completely on a cash basis, nor to curb the inflationary movement without the aid of other measures. It would, however, have accomplished the following highly important purposes:

1. It would have siphoned off more of the surplus purchasing power created by the defense spending than could have been done by any other means. Hence, it would have been a more effective safeguard against inflation than any other fiscal measure.

2. It would have provided more current cash revenue for the defense financing than any other fiscal measure. Hence, it would have minimized the resort to general market borrowing, a procedure which tends to intensify the inflationary pressure on prices.

3. It would have rendered unnecessary, or certainly far less necessary, the abominable Revenue Act of 1941.

Needless to say, my suggestion was not followed. In the hearings on the 1941 tax bill, John L. Sullivan, Under-Secretary of the Treasury, was asked to comment on a gross income tax proposal made by the president of the National Small Business Men's Association. He said:

We have considered that, and the outstanding virtue of the proposal, in our opinion, is that it enables the wage-earner to pay as he goes, or to set aside as he goes, sums that will discharge his tax liability the following March.

On the other side of the ledger is the discrimination against the wage-earner, the inability to enforce that same proposal on agricultural labor, on professional people, and on self-employers.²

This was a weak basis on which to reject a general withholding tax. Both the administrative difficulties, and the extent of the discrimination ensuing from a failure to get universally complete results, were exaggerated. It is a significant comment on Treasury acumen to find that within six months after this summary rejection of a general withholding tax, the President had begun to talk about a substantial broadening of social security taxation and coverage, to include, among others, farm labor and domestic servants, and also that the head of the Treasury Department had laid withholding tax proposals before the Ways and Means Committee. With marvelous ineptitude, the Treasury architects of the federal fiscal system have built the roof of the house, and they are now trying to put a foundation under that roof.

²U. S. House of Representatives, Committee on Ways and Means, *Hearings on Revenue Revision of 1941*, p. 63.

The social security aspect of these recent proposals is camouflage. The real objective is more money to finance the defense program. The use of social security revenues for current purposes, a practice which has been followed from the beginning of that program, coupled with a steadily rising public debt which brings ever closer the prospect of repudiation via currency devaluation, means that the ultimate discharge of the obligation being created today in the name of social security may be made in 10 or 25 cent dollars instead of in terms of the 59 cent dollar to be collected now from the workers as a social security tax.

The proposal to levy a social security tax for defense purposes recalls the automobile purchase tax which was laid on the German workers. Each worker subjected to this tax was supposed to be accumulating advance payments on the Nazi stream-lined *Kraft durch Freude* automobile that would eventually be his. The money went into factories to produce tanks and airplanes, and the only free rides which Germans have enjoyed, so far, have been those in the army's tanks, trucks, and bombers.

The recent proposals have involved an increase of the employer's part of the social security taxes. These will add to production costs and will be shifted wherever possible through higher prices, a process that will be facilitated by the current instability and generally upward trend of prices. Thus, the rise of the inflationary price-wage spiral will be promoted rather than curbed. As for the workers, it is apparently assumed that they will not take a dose of taxation directly. It must be sugar-coated with social security treacle before it will be swallowed.

I have maintained from the beginning that a tax on income payments to individuals, collected as far as possible at source, is the easiest to bear of all taxes. In so far as

a tax of this character, levied at a substantial rate, should prove to be an effective curb on general price increase, it would to this extent protect the low-income groups against the worse evil of inflation. It is the only effective way by which to broaden materially the income tax base, since the present type of income tax cannot be applied to small incomes without great administrative difficulty and without serious hardship to small taxpayers.

It is already plain that the Revenue Act of 1941 is so drastic as to constitute a substantial barrier against further tax increases. According to press reports, there is strong opposition to the introduction of a withholding tax at the beginning of 1942, because the taxpayers will then be struggling to meet the ferocious tax increases imposed on 1941 incomes. This opposition is well founded, for the tax increases that must be paid in 1942 cannot be paid out of income. They will be a levy on capital, since most of the income on which this levy was made had been received and spent before the tax increase became effective. The vicious practice of retroactive taxation of income is responsible for this result.

I have said elsewhere that retroactive increase of the tax rates on incomes is the very dregs of fiscal morality.³ It is a violation of all our instincts of fair and equitable treatment, although it is a perfectly logical application of the current misconception of ability to pay, a misconception which has led to the imposition of severe taxes upon sums in arithmetic in the mistaken belief that taxes are thereby being levied on income in accordance with the principle of ability to pay.

³ See my paper, "Some Errors and Fallacies of Taxation as Exemplified by the Federal Income Tax," in the forthcoming *Proceedings of the Thirty-fourth Annual Conference of the National Tax Association*.

If a withholding tax had been introduced a year ago, it would still have meant that most people would be paying two years' income tax in one, and this will be true whenever the two levies are imposed coincidentally. But the tax load on small- and middle-bracket incomes was so much less under the 1940 Act, by comparison with the load under the Act of 1941, as to have made the transition far easier then than now. Moreover, the price inflation had not then developed far enough to provide as much justification for opposing tax increases as exists today. And it may be added that the inauguration of a withholding tax then would no doubt have been an important factor in preventing the advance of this inflation.

I still believe that it would be wise to introduce a general withholding tax, for much the same reasons which lead me to believe in laying the foundation of a house before putting on the roof. But in order to do this, the taxpayers should be freed from the crushing increase of burden retroactively imposed by the 1941 Act. During the month of December, Congress, if it would, could repeal the increases of income tax rates made by the 1941 Act, and provide that the ordinary income tax payable on 1941 incomes should be computed at the rates of the 1940 Act. Then it could provide that a withholding tax should apply to income receipts on and after January 1, 1942. There would be no loss of revenue to June 30, 1942. On the contrary, there would be a large increase in receipts over what they will actually be to that date.⁴

A reversion to the 1940 tax rates would involve tacit

⁴This paper was written in November, 1941. The groping and delay in fiscal matters continued, although the nation was at war within a week after the meeting of the Tax Institute on December 1. In lieu of the above suggestion another approach was suggested by the writer in late December. The essence of this proposal was that the normal tax be collected at source, thereby becoming the basic withholding tax, and that provision be made

admission that retroactive taxation of income is a thoroughly vicious and unjust practice. Since this is precisely what it is, no harm can be done to have Congress recognize a fact already fully apparent to every taxpayer. No ill will was ever created by a handsome apology from the party who was clearly in the wrong. On the contrary, the provision of relief from taxes, which can be paid only by selling assets or increasing private debt, should increase the popular good will towards Congress, and supply welcome support for a withholding tax applicable to future, and not to past, income. All of the political elements in the situation would indicate that it would be smart to accept now the program I am proposing. The closer we get to November, 1942, the greater the political hazards of any kind of tax increase. These hazards will be far greater still, if taxpayers are obliged to impair their net worth by beginning the payment of income taxes at the 1941 rates on March 15.

The rate of the withholding tax during the first year should be moderate, in recognition of the fact that most people do not pay income tax out of the income of the taxable year, and in recognition of the fact that there had not been adequate notice of the withholding tax. In the calendar year 1943, the withholding tax rate could be advanced, since the ordinary income tax load would be somewhat reduced by reason of deduction of the tax withheld at source from gross income. All that is needed to set up such a program is a little wit and a little courage, and a considerable amount of directness in explaining to the people the economics of the present situation.

for quarterly reporting and payment of surtax. Transfer of the individual's tax liability from 1941 income to 1942 income would have made this significant improvement of the income tax possible. Cf. H. L. Lutz, "A Current Basis for Income Tax Payment," in *The Watch Dog*, VII (December, 1941), published by the National Economy League.

It should be pointed out, also, that the excess profits tax tends to stimulate inflation because it removes all incentive from business to watch expenses carefully. When the tax takes as nearly all of the profit as it now does, and particularly when the tax is deliberately rigged to do this instead of being an intellectually honest tax on bona fide excess profits, the ordinary standards of prudent management tend to become inoperative. Money will be more freely spent for equipment, for advertising, for wage increases, and for every other kind of expense, since the tax will take most of it, if it is conserved as profit. The recent suggestion for a tax of 100 per cent on all profit above 6 per cent of invested capital would provide a still greater excuse for the dissipation of potential earnings and for relaxation of the efforts to produce earnings. The rapid dissipation of earnings, through more lavish expenditures for wages and in other ways, will create still greater pressure on the price level and thus speed up the inflationary spiral.

In the remainder of this paper I propose to outline briefly some of the characteristics of a tax on gross income payments to individuals, and to offer some suggestions relative to its place in the present and the future federal fiscal program.

THE NATURE AND SCOPE OF THE TAX

1. The tax should be imposed upon all income payments to individuals upon which Congress has the constitutional power to levy, with the exceptions noted below. Thus,

- a. It would apply to all payments of income for personal service or for the rental or hire of land or capital. That is, it would apply to all payments of salaries, wages, bonuses, commissions, or other compensation for services, and to interest, dividends, net rents, and

royalties; and to annuities, to the extent that the payment constitutes income as distinguished from a return of the capital.

b. The tax would not apply to gross business receipts.

c. It would not apply to payments of income which are exempt by constitutional interpretation, such as the interest on state and local bonds, or by contract between the federal government and the recipient of the income, such as the interest on federal bonds to the interest of the contractual arrangement.

d. It would not apply to payments representing the purchase of goods or property.

e. It would not apply to capital gains.

2. Persons liable to the tax would be all those who receive taxable income payments. The principal difficulty of distinction and application here would arise in the case of the self-employed, a category which would include individual businessmen and the professional classes. The total gross receipts of a merchant, or doctor, or lawyer, do not constitute income payments to them by others as the term is used here. As I would interpret and apply the gross income concept in these cases, it would be the amount of income taken out of the business unit or the professional office by the operator thereof, whether as a drawing account, or as a final, year-end payment to himself.

While it may constitute an apparent discrimination in favor of farmers, and of merchants who eat or wear goods from their respective stores, there is no feasible way of taxing gross income receipts in kind, just as there is no way of taxing income in kind under the present income tax. Quite apart from the administrative problems, there is the even more important fact that taxes are payable only in money. If farm produce were receivable for a portion of the farmer's income tax, it would be sensible to include produce raised and consumed on the farm as income. As it is, farmers could easily be placed in the predicament of

owing more income tax than their net cash receipts would cover. Even business corporations have been in this embarrassing situation.

3. With respect to the rate of tax, my initial proposal was 10 per cent. Evidently, wide discretion is possible here, and my choice of a tenth may have been inspired by reflection upon the fact that for many centuries men rather cheerfully gave a tenth to the church, without impairing either their incentive or their productivity. In the present emergency, which is regarded by many to be at least as serious as the support of the church, it seemed we could not do less. Perhaps we should do even more, for we are doing the Lord's work by fighting the Devil.

4. On the matter of exemptions, there is also room for difference of opinion. In my original proposal, no exemptions were contemplated. I still believe this to be sound policy, for the following reasons:

a. Exemptions will reduce the yield of the tax. This may become serious, for any given exemption, however meritorious per se, tends to breed others. If you don't want the camel in the tent, don't let him get his head in.

b. Exemptions magnify the administrative problem, particularly in the case of corporate interest and dividend payments.

c. This is, after all, everybody's country, and everybody's war; and the cost of defense should be universally borne, to the extent of this tax.

d. Exemptions will not protect the small income group if the result of a liberal exemption policy is to make the tax an ineffective curb on price distortions. At any rate, the tax would tend to set a limit to the deprivation of the low-income group. There would be no limit under inflation.

e. If there must be an exemption, however, the Canadian plan of determining it should be used. The Canadian law asks, merely, "Is your income under \$600 if single, or under \$1,200 if married?" If so, no tax is withheld. If the income exceeds these amounts, the tax is withheld on the whole income.

THE ADMINISTRATIVE PROCEDURE

The tax should be collected at source in the greatest degree possible. This method was tried for certain classes of payments under the Act of 1913. It was generally unsatisfactory and shortly abandoned.⁵ But the federal income tax has always allowed an exemption, or personal credit, to every taxpayer, a practice which made both the withholding and the refunds more complicated. If no exemption is allowed, refunds present no problem. Under the Canadian system, refunds are troublesome, especially in the case of taxes withheld on interest and dividend payments.

A significant change has been introduced by the social security legislation, under which the employee share of the tax for old age benefits is withheld. Because of these laws, the entire business community has been obliged to install the facilities and the technique of deducting the proper tax, and of accounting to the Treasury for the sums collected. In short, we are now familiar with the principle of withholding and are equipped to operate under it, while in 1913 the whole matter was new and unfamiliar.

Obviously, withholding will not be applicable to the self-employed, for these persons pay income to themselves. From them returns will be required, but they should have the privilege of making frequent payments on account in order to avoid that vice of the present income tax, namely, the accumulation of a tax liability to be discharged long after the income on which the tax is levied has been received and spent.⁶

With respect to a large proportion of the self-employed, the return which is now required for the purposes of the

⁵ Cf. "Report of the Committee on the Federal Income Tax," *Proceedings of the National Tax Association*, 1915, pp. 234-90.

⁶ Cf. the reference in note 4 *supra*.

present income tax will afford an informational check upon their income payments to themselves. The number in this group, with gross personal incomes too low to be affected by the current requirements relative to the filing of returns, is probably so small that the failure to reach all of them would be of minor consequence, both with respect to the revenue and the ultimate equity of the tax. That is, this failure should be no more disturbing as an argument against the tax than is the fact that the present income tax does not actually reach all income which is legally subject to taxation.

Such a tax would increase materially the number of persons who would be classified as withholding agents. Those concerns which now withhold and remit social security taxes would need only to universalize the present technique in order to withhold the tax on all wage and salary payments. Corporations would need to extend the technique to dividend and interest payments, although in the case of bond interest, banks would probably become the principal primary withholding agent.

All individuals who pay wages, salaries, or interest, would likewise become withholding agents, but such persons, if engaged in business, are already serving in this capacity under the social security taxes. In so far as those various payments are admissible as deductions in the determination of net income under the present income tax, an informational check will be provided by the present returns upon the amounts of wages, salaries, or interest paid, and hence upon the amount of tax on gross income payments for which the withholding agent is liable. Every withholding agent should be permitted or even required, to make regular, frequent remittance of the withheld tax.

His final return and accounting could easily be combined with his present income tax return.

Payments of wages and salaries which are now treated as nonbusiness expense, and hence do not appear in income tax returns, would be made chiefly by individuals. The one important category of such payments is that for domestic servants. It is safe to assume that a large proportion of the employment of domestic servants will be by those who will be required to make returns under the present income tax law. The addition of a few questions to the current income tax returns will provide an adequate informational check relative to this class of payments.

LEGAL ASPECTS OF THE PROPOSED TAX

It would be both improper and useless for a layman to venture an expression of opinion on the purely legal aspects of the proposed tax. Since the Sixteenth Amendment does not define income, it would appear clear to the mind untutored in law that this Amendment is not to be restricted to a concept of income which is as unreal, arbitrary, and fantastic, as the present statutory net income. Congress has as much power, and in my opinion far more justification, to impose the tax upon gross income as it has to impose it upon a fanciful net income. There should be no basis for a serious challenge of such a tax on constitutional grounds.

PLACE OF THE PROPOSED TAX IN THE FEDERAL TAX SCHEME

Full consideration of the place of a tax on gross income payments in the general plan of federal taxation requires a distinction between the emergency situation and the long-run federal revenue program. In my early thinking about a tax on gross income payments to individuals, the imme-

diate and urgent problem of defense financing was the primary consideration. The principal concern was to get into operation a tax which would produce large revenue quickly from the maximum number of taxpayers, and which would thus aid in curbing inflation while it minimized debt increase. I, therefore, advocated it as a defense tax, to be collected during the emergency or for a specified period.

The tax on gross income payments would naturally become a kind of foundation income tax, and any amount withheld under it should be admitted as a deduction from total income for the purposes of ascertaining so-called net income. It would be highly improper to deny such a deduction, for the taxpayer would otherwise be obliged to pay heavily graduated rates upon a part of his income which he never saw, nor touched, nor used.

During the emergency it would be necessary to retain all of the present forms of taxation, in addition to the proposed tax. As indicated above, the income tax rate schedule should be relaxed at least to the scale provided under the 1940 Act. The nondefense expenditures of the federal government have been so inflated, during the past decade, as to absorb a substantial proportion of the yield of existing taxes. In the minds of many citizens there is an overwhelming case for drastic cuts in the nondefense spending, but as yet this view has not impressed seriously either the Congress or the members of the Administration. Even if it should prove possible to reduce nondefense spending by as much as two billion dollars a year, the defense costs have not yet reached their maximum, and it is imperative that we avoid the dangers which inevitably follow from inordinate increase of the public debt.

If we shift our attention from the immediate objective

of defense financing to the more remote objective of a long-range fiscal program, we perceive that various difficult issues are emerging. Two of these, of direct concern here, are federal-state revenue relations, and the growing concentration of fiscal power.

The subject of federal-state fiscal relations is a hardy perennial in the garden of things-that-something-should-be-done-about. The Treasury has assembled a staff to study the matter, and, presumably, to make recommendations. The National Tax Association has established a committee for a similar purpose. Numerous individuals and institutions have offered suggestions. Certain proposals are made here looking to a solution of both of the difficulties mentioned above. This is done because of concern that the kind of solution which is likely to be offered for the federal-state revenue tangle will involve still further concentration of fiscal power.

Much has been said of late years about the concentration of economic power. Little has been said about the concentration of fiscal power in Washington, although, in my opinion, it constitutes a far greater danger to our institutions and our liberties than any concentration of economic power. It is always possible to correct undesirable economic concentration by economic means, but there will be no way of breaking the grip of fiscal despotism in Washington once it has acquired firm hold.

A recent expression of the doctrine that greater federal concentration is the correct answer to our fiscal and administrative problems is to be found in the address by Marriner S. Eccles before the National Tax Association on October 14, 1941. Mr. Eccles spoke as an individual, but it is obvious that his views on this subject would not be repugnant to many who are today influential in shaping

national policy. His remarks on the subject of revenue adjustment were in part as follows:

If we are to be successful in the objective of creating a high and steadily increasing demand for the products of industry after the defense period, we must adopt a progressive tax system bearing heavily upon savings concentrated in creditor areas and lightly upon the great mass of families of the low income groups. This means that we must get rid of, or at least check the growth of the sort of taxes to which our States have unfortunately been forced to resort more and more in recent years. I am referring to the general sales taxes and the taxes on gasoline, tobacco, and other articles of mass consumption. . . .

If we are to make progressive taxes the major element of our national tax structure, however, it will not be possible to continue the present system of having both the States and the Federal government levy taxes on corporate and individual incomes and transfers at death. . . . In the end, the only thoroughgoing cure for these difficulties lies in a drastic reallocation of taxing powers between the States and the Federal government. Such an allocation would involve restricting the right to levy taxes on income, gifts and bequests wholly to the Federal government with redistribution of a share of the revenue from these sources to the States. I know how controversial this subject is but I think we will have to face, quite frankly, the implication that State revenues will tend to consist more and more of taxes shared with the Federal government and of grants from the Federal government, which already make up about 14 per cent of States revenues. . . .⁷

In short, Mr. Eccles would eliminate the federal-state revenue conflict by a further great concentration of fiscal power in Washington. It is proposed that the states abandon entirely the sales tax, the gasoline tax, and all excise taxes; and that they surrender all taxes on incomes and inheritances to the federal government. The states are to be chiefly dependent for revenue upon federal grants, and such portion of federally administered taxes as they might secure by begging or political jockeying. It is hardly necessary to point out that such a program would involve the

⁷ In the forthcoming *Proceedings of the Thirty-fourth Annual Conference of the National Tax Association*.

complete destruction of the states as sovereign entities, and that such an enormous concentration of financial and administrative power in Washington would greatly facilitate the transition to a totalitarian state.

In contrast to this proposal, and in direct opposition to its basic premise, the following scheme of federal-state revenue allocation is offered for the consideration of those who may prefer to achieve a substantial decentralization of fiscal and administrative powers:

1. Federal Revenue Sources:
 - a. The customs
 - b. Excise taxes on commodities
 - c. General sales taxes
 - d. A flat rate tax on individual gross incomes
 - e. Payroll taxes for social security benefits, really an insurance premium rather than a tax
2. State Revenue Sources:
 - a. Death taxes
 - b. Business taxes, including taxes on business net income
 - c. Taxes on individual income, at proportional or progressive rates as may be desired
 - d. Gasoline and motor vehicle taxes
3. Local Revenue Sources:
 - a. The property tax, a field now being entered by the federal government via the use tax on automobiles and boats
 - b. Miscellaneous local revenues
 - c. State aids and grants

This outline is far from comprehensive, but it will suffice to indicate the general scheme. With equal brevity, the case for this program will be outlined.

1. The revenues suggested for the federal government possess the following characteristics:

- a. *Productivity.* They are much less affected by variations in economic activity than are the taxes on business and individual net incomes. They are taxes that will produce revenue currently, with

little lag between levy and collection. This is highly important in budgetary calculations, if and when we recover from the fiscal dementia that has been responsible for the illusion that a perpetual deficit is the best evidence of a beneficial condition.

b. *Universal distribution.* The federal government exists to serve all of the people, and all parts of the country. It is both logical and just that the cost of services intended to benefit all citizens be met by federal taxes which are borne by all citizens. The populous creditor areas will continue to contribute the bulk of the federal revenues, but there will be a wholesome diffusion of the federal tax load which is impossible under the existing system.

The rate of withholding tax on individual income payments might be used as the flexible factor in federal budgeting. That is, this rate could be adjusted from year to year as required in order to produce the remainder of the revenue needed, above other tax receipts, to balance the budget. Since such a tax would reach every corner of the nation, changes in its rate would immediately demonstrate to every voter and every citizen the significance of the policies being undertaken in Washington, and it would thus provide an acid test of whether or not these policies were being approved.

c. *Elimination of the excesses of progressive taxation.* Progressive taxation of incomes and estates at the rates now found in federal tax laws can have only one result, namely, the destruction of the private enterprise system and the economic liberties which are dependent for survival upon that system. The present federal tax system has "frozen" the economic order at its current stage of development. No new large-scale mass production industry can arise in this country under this tax system, because the taxes would absorb the funds required for expansion while they would destroy all incentive to do so. Progressive taxation is the most powerful instrument available for the peaceful achievement of the socialist state, and this purpose constitutes the only valid argument in its support. When a future Edward Gibbon writes the history of the decline and fall of the American Republic, the date he will use to mark the beginning of that decline will be March 1, 1913. On that date, the people sanctioned federal taxation of incomes with no thought of restraint upon the abuse of this method, or of the evils that would be produced by abuse.

d. *Elimination of federal waste.* In the vocabulary of deficit financing, there is no such term as "wasteful spending." When government sets out to use its fiscal processes to manipulate the economy, to redistribute wealth, or to assure the good life to all citizens, the ordinary criteria of sound budgeting are discarded. The quantity of

public spending, rather than its utility to the economic system, becomes the principal, if not the sole standard. When the fiscal objective becomes the sheer quantity of spending, no amount of "public investment" or "public asset" camouflage can disguise the fact that enormous wastes are not only probable, but inevitable.

Paralleling the concentration of fiscal power in Washington has gone the concentration of fiscal waste. As the federal government has moved toward absolute domination of revenue resources, it has become correspondingly wasteful and imprudent. It is too far removed from the people to enable them to have definite knowledge of these wastes, or to exercise an effective curb upon them. Decentralization of fiscal power will compel the introduction of a new and higher standard of values in the federal spending. It will restore to effective operation the principle that the people should support the government instead of being supported by it.

The above program would relegate the use of progressive taxes to the states, but the rivalry of the states will be an effective curb on abuse of the principle.

2. The significance of the proposed program, from the standpoint of the states, is that it will increase their revenue potentialities. This will promote the following desirable results.

a. *Preservation of the states as the integral members of a federal union.* In so far as state revenue resources are improved, they will become less dependent upon the federal treasury. State prestige will be restored, state morale will be revived, and the federal obligation to provide aid will be materially reduced if not eliminated.

b. *Restoration of private enterprise.* The stagnation of private business was the principal reason given for the large-scale deficit spending which was undertaken to relieve unemployment. It is an obvious fact that the course of government policy has not been shaped, in recent years, with a view to the speediest possible termination of public relief through the prompt absorption of workers into private jobs. Rather, this policy has been aimed at a perpetuation of government support, with little regard to the establishment of those conditions under which private enterprise could resume its normal role of the principal source of economic opportunity. It will require changes of governmental policy at other points than

taxation to revitalize the enterprise system, but the tax relief that would be supplied by the above program would be both an important and a necessary move in the right direction.

c. *Equalization between debtor and creditor areas.* Under the program proposed above, there would emerge a certain degree of competition among the states to attract business and residents. When expressed through the form of tax adjustments, such competition may be regarded as wholly desirable, because it is the most effective way of dealing with the condition of which Mr. Eccles complains, namely, the disparities of wealth, income, and business activity, as between creditor and debtor areas. The present approach to this problem, which is federal taxation of the creditor areas in order to provide funds for the support of the debtor areas, is wrong in principle and futile in practice. It perpetuates the disparity, and removes all incentive to a better geographical distribution of wealth, industry, and population. It thus creates a strong case for continuing and extending the vicious circle of heavy federal taxes, demoralized state revenues, greater state aid, heavier federal taxation, and so on.

I am aware that taxation of business is usually regarded as a minor factor among the causes of industrial migration. This is the more likely to be true while the same heavy federal taxes on business must be paid regardless of location. Even if the process of relocating industrial or commercial establishments were to be slow, the variations of state taxation would become a more effective incentive in this direction, once the neutralizing effect of uniform federal taxation were removed.

Heavy federal taxation of personal incomes and of estates also neutralizes the factor of location, and likewise tends to perpetuate that geographical concentration of wealth of which Mr. Eccles complains, while it renders futile any hope of diminishing the disparity between creditor and debtor areas. I suggest that state rivalry in the taxation of estates and incomes would promote a diffusion of domicile, and thus moderate both the geographical concentration and the present unbalance between debtor and creditor areas.

In so far as the debtor areas were successful in attracting business or residents, the greater spending of income in those areas which would follow, would improve their position and thus correct, in that degree, the geographical unbalance that now constitutes ground for complaint. While I disapprove of tax progression, I should not be unwilling to see the states use it, because there could be little danger of abuse as long as the states were free to compete with each other in arranging tax rates and tax systems.

The tendency of the states to erect foolish interstate trade barriers, whereby they seek to limit that trade which tends to create an "unfavorable" balance of payments, has certainly been fostered, if it has not been wholly caused by, the deadening effects of heavy federal income and estate taxes. Under these taxes the states have little opportunity to attract either business or residents with income to spend. They, therefore, try to prevent outsiders from doing business within the state and from drawing income out of the state by such business. The best cure for this paralyzing provincialism is to introduce a healthy rivalry among the states in attracting both business and residents. In so far as this rivalry were to result in a better geographical distribution of business and of domiciles of those having substantial incomes or estates, there would be an equalization between debtor and creditor areas. This equalization would be accomplished through the forces of competition, and not by the bureaucratic methods advocated by Mr. Eccles.

In preparing this brief outline, no attempt has been made to estimate the revenues which might be expected under it for federal and state purposes, respectively. It is useless to pass judgment upon it from the standpoint of the defense program, or from the standpoint of the inflated non-

defense federal budget. Federal revenues would probably be somewhat less, and state revenues would be somewhat more, relatively, than they were in the immediate pre-defense period. This would be eminently desirable, since every addition to state and local fiscal capacity would reduce, by so much, the federal expenditure obligations for relief, for public works, and for similar purposes. The stimulation of enterprise, which would follow the elimination of the present crushing federal taxation, would greatly reduce the proportions of the relief and welfare load now being carried, and, at the same time, the improved finances of the states and cities would put them in better position to assume such relief and welfare responsibilities as might remain as a public cost.

CONCLUSION

Two long-range fiscal programs are being currently advocated. One aims at complete fiscal centralization, the other at a substantial fiscal decentralization. My estimate of the final effects of the two programs is as follows: Continuing and more complete centralization of fiscal power will lead to the demotion of the states to provincial status; it will produce serious stagnation of private business as soon as the defense boom ends; a return of mass unemployment; a strong case for further huge federal deficits to provide work and wages; an indefinite increase of the public debt; and ultimately, financial collapse leading to totalitarianism in some form. A large stream of insidious propaganda is issuing from Washington to pave the way for these results by telling the people that a public debt is a public blessing, and that the American way of life can never be endangered by debt increase.

On the other hand, a substantial decentralization of

fiscal power, for the accomplishment of which a tax allocation program has been offered, will promote the preservation of the federal union and of the rights and liberties assured to us as citizens under the federal Constitution; it will promote the restoration of a vigorous private enterprise system through substantial tax relief; it will reduce the obligations of government, and hence lead to a lower cost of government; and it will so distribute the cost of supporting the federal government among all of the people, that everyone who votes for a president or a member of Congress will be aware of the significance of the policies which the national government proposes to apply.

CHAPTER VIII

FORCED LOANS AND SOCIAL SECURITY TAXES AS INFLATION REMEDIES

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THE FISCAL approach to the inflation problem rests on the insight that spending power is tending to outpace the physical flow of goods to consumption markets. On the side of spending power, there are two sets of forces behind the rise. One originates in the field of "administered prices." Many wage rates and many prices of farm products and other raw materials are being "administered" upward, either by organized economic groups or by government agencies under pressure from such groups. The second set of forces increasing spending power would still be effective, however, if all these prices remained constant. Rising employment, longer working hours, "up-grading" of labor as skill is developed or discovered, promotion of executives to larger responsibilities, higher business profits from expanding volume, increased farm incomes from larger output—all these spell higher money incomes, even though each service is paid for at an unchanging price. On the side of physical goods, the physical flow to consumption is being squeezed by defense activity. We have now reached the stage where defense is growing faster than total output, and thus cutting into civilian supplies.

There is a general consensus among students of money

that it is no responsibility of monetary and fiscal policy to cope directly with the "administered prices." This is chiefly a problem to be solved by the government agencies concerned with labor, agriculture, coal, transportation, etc., in cooperation with the organized economic groups in those fields; though fiscal policy is responsible for checking the rise of living costs attributable to the other sets of forces described above, and thus creating a favorable setting for stabilization of these prices. Contrary to the popular and journalistic impression, machinery for regulating the administered prices already exists. Price control legislation has a part to play here, not in setting up machinery but in formulating a policy. Price increases in this field should be tolerated only when it is clear that demand at existing prices cannot be satisfied, and that the price increase has a useful role to play in allocating available supplies, or in expanding those supplies, or both.

Even complete success in holding down the "administered prices," however, cannot prevent the other two sets of forces from increasing spending power and reducing the physical flow to consumption. This tendency can be dealt with only by immobilizing enough of the increased spending power to keep actual spending down to the level which available goods can absorb at acceptable, non-inflationary prices. Such an immobilization can be secured by fiscal measures; and, in the absence of a comprehensive system of consumer rationing on the German model, it can be secured *only* by fiscal measures.

INADEQUACY OF "PRICE CONTROL"

To avoid misunderstanding, the writer feels it necessary to repudiate explicitly the heresy that price control *without consumer rationing* can halt inflation at the retail level.

This heresy is the current refuge of "business as usual." Until after the actual declaration of war, for instance, the public was given to understand that prices of rubber tires could be kept down while total supplies were drastically reduced, without rationing consumers. In short, despite over-all shortages of tires, each individual consumer persuaded himself that the shortage did not apply to him. This sort of arithmetical hocus-pocus, which plainly should not deceive anybody who has passed the third grade, has since then been dispelled as regards tires and automobiles. But wishful thinking still keeps most of the public from seeing that the inflation problem consists in a shortage of goods relative to spending power, and keeps up faith in solutions for inflation which control prices while ignoring shortages.

One would have supposed that the United States had learned between 1920 and 1933 the difference between enacting a prohibition and making it stick. But, apparently, this lesson has not been applied to price control. If retail prices are held down for a while, while spending power keeps on outpacing output, we shall find sellers running out of goods long before their customers run out of money. Consumers who have money burning their pockets have an obvious mutual interest with their dealers to go above official prices in order to get delivery. The problem of sifting complaints and policing price control under these conditions, while perhaps not insoluble, would at the least be a huge added burden for an over-burdened government.

Combining price control with consumer rationing would probably make the policing problem more manageable. But the chief reason for adopting rationing is to keep protective foods, essentials of clothing, etc., from being bid up out of reach of low-income groups. Dangers of this sort

are not serious in the United States. To build up a rationing system merely to help price control check inflation would probably not be worth while. In any event, it takes time to build the machinery. The British system, after two years of feverish work, has still serious gaps. But inflation was already a problem in 1941, and will be a worse problem in 1942. In the second quarter of 1942, as may be seen by an easy projection of Treasury figures, present revenue measures will leave us with an excess of Treasury cash outgo over cash income amounting to a good five billion dollars for the quarter, or somewhere about 20 per cent of total income payments received by the public. An inflation threat of this magnitude cannot be dealt with by "jawbone control" or by pious hopes for 1943. Quick action is needed; and in default of price control and consumer rationing, it *must* be fiscal action.

MONETARY WORKINGS OF FORCED LOANS AND TAXES

Assuming that spending power cannot be immobilized by rationing—i.e., by closing the channels of spending for each individual separately—there are two basic techniques open to government for keeping excess spending power off consumption markets. One is to take spending power directly from the public by taxation. The other is to encourage the public to divert money from spending to saving. As A. F. W. Plumptre has pointed out in the *Canadian Journal of Economics and Political Science*, it does not much matter in the short run whether the savings are put into government bonds or not—unless they are themselves a stimulus to private investment, increasing the competition for goods. Priorities and other limitations on investment make this unlikely under war conditions.

The techniques of taxation and stimulating savings shade

off into each other. The immediate effect of taxes, for one thing, is felt largely through savings. Down to March, 1942, this is the only possible channel for the action of 1941 income taxes. Beyond this, the forced loans and social security taxes, which are the special topic of this paper, represent something intermediate between ordinary savings and ordinary taxpaying.

Tax Aspect of Forced Loans

A forced loan, from the short-run standpoint, is a sweetened tax—that is a tax accompanied by a promise of refund or by the creation of a valuable claim to contingent benefits (such as unemployment benefits or “dismissal compensation”). Accordingly, any conceivable type of tax may be converted into a forced loan. As Professor Walter Morton has pointed out, this applies even to retail sales taxes.

Of the multitude of conceivable forced loan schemes, however, only two types seem to need detailed discussion in this paper—the Keynes Plan with its variants, and the proposal to expand social security arrangements. In its tax aspect, Keynes’ standard proposal has something in common with Professor Lutz’s “gross income tax.” That is, its base is to be individual income, gross of exemptions, but net of deductions (business expenses, other taxes, etc.). But it should be noted that Keynes proposes combining this levy with family allowance payments, which would at least offset the levy for low-income families; and if family allowances are out of the question, he favors basing the levy on the excess of net income over exemptions. The practical schemes operating in England and New Zealand are of this sort—they are sweetened, supplementary income taxes. The rate structures proposed for the Keynes Plan

levies are always somewhat regressive, but not regressive enough to offset the progressivity of income tax rates.

The social security forced loan schemes are sweetened wage taxes. As such, they are flat-rate levies, not upon income in excess of a few hundred exempt dollars, but upon income up to a certain level. Furthermore, they apply only to specific types of income-wages and salaries of "covered" employees.

Public Debt Aspect

Besides its tax aspect, every forced loan scheme has a public debt aspect. The sweetening is inevitably an addition to public debt. For convenience, we may appropriate the label "certificate"—which happens to be unused momentarily. The certificate may be either a definite debt or a contingent debt (as is, for example, an insurance policy). It may have a definite maturity, or it may have a maturity date set with relation to the hoped-for end of the war. In view of the monetary purpose, it must be designed to prevent the recipient from using it as money or cashing it prematurely. Thus the certificate must be nonnegotiable and nonredeemable (unless in exceptional circumstances, such as sickness or injury).

Impact Effects of Forced Loans Compared with Taxes

The fact that a forced loan carries a certificate, of course, not only sweetens the tax but changes its monetary effects—both at the time of the levy and later on. To begin with impact effects, the fact that a person gets a certificate instead of a tax receipt makes him wealthier, and to some extent more liquid. Accordingly, it reduces the incentives to save and to hold cash assets. Thus forced loans will have a larger influence in reducing voluntary saving, and a

smaller influence in reducing expenditure, than taxes of like form and amount on the same persons.

At low-income levels, the impact effects of forced loans and taxes, dollar for dollar, will be almost identical. Voluntary savings are so small, and so far committed under contracts for life insurance and for amortization of debts, that both taxes and forced loans must come chiefly from consumption spending. As we move up the income scale, however, a larger proportion of income is saved, and the saver's range of uses for his savings is wider. Hence taxes will tend to reduce both spending and saving. Forced loans, on the other hand, will be treated largely as substitutes for voluntary saving, so that their effects on spending may be small or even nil.

Since social security schemes are for levies largely on low-income groups, the existence or nonexistence of a certificate makes little difference in the impact effects. For Keynes Plan levies, however, which exempt the lowest income groups and reach up into the higher brackets, the danger of leaving high-bracket spending unaffected is serious. This, of course, is the chief reason why Keynes and his followers propose mixing tax and forced loan measures, with forced loans predominating at the bottom of the scale, and taxes at the top.

Long-Range Effects

Public and professional interest in forced loan schemes hinges largely on the monetary effects expected in the post-war period. Keynes and his followers have stressed the merits of planning to pour out spending power during the demobilization period, as insurance against postwar deflation. The difficulty is that funds may be poured out not into a primary postwar depression like 1921-22 (let alone

a secondary postwar depression like 1930-33), but into a postwar speculative boom like 1919-20. The economic logic of the scheme, of course, calls for waiting until deflation really threatens; but its political logic calls for waiting until certain psychological tensions relax, which may be an inopportune moment. Thus in 1936, the time for tapering off the government's deficit spending arrived just as the veterans and the Congress finally concluded that the principle of spending to restore prosperity definitely justified the bonus!

The social security schemes for unemployment and dismissal benefits, since the outpayments called for are contingent, offer a certain amount of automatic protection against such a miscarriage. But even here, there are dangers. If hundreds of thousands of workers make an easy transfer from wartime to peacetime industry, and are still entitled to "dismissal compensation" from the funds built up by war industries, an inflationary push may result. This would have happened, had we had such a scheme, in 1919. Unemployment benefits are safer. Old age benefits, being spread over long periods, are safer yet; but they also lack the merit of cushioning the demobilization shock.

It should be noted that if we now levy taxes instead of forced loans, we shall also come out in a position to act against deflation. This policy will bring us out with a much smaller public debt, by avoiding the creation of forced loan certificates. If we end the war with a relatively small public debt and a relatively "sound" record of war finance, a postwar "reflation" campaign will be both feasible and acceptable to the public.

Forced Loans and Budget Balancing

While it is not generally recognized, adoption of a forced loan program sets up a barrier against going over to the

so-called "Swedish budget"—balanced not year by year, but on an average, over a period of prosperous and depressed years. The war seems to have damped professional and political interest in this compromise between traditional "soundness" and the use of deficit spending to cure depressions, but the plan remains a promising one for use in the reconstruction period.

A war period is not prosperity in a "real" sense. The Swedish budget implies that in prosperity private investment will exceed private savings, the excess being financed from the proceeds of government debt retirement. The needs of armament for key materials, equipment, and labor, inevitably damp private investment, so that there is a tendency toward an excess of savings, and a considerable government deficit may exist without inflation. If war taxes are so levied, however, as to reduce savings powerfully, they may come close to covering total expenses without bringing on deflation. On the other hand, to the extent that we drain off spending power by forced loans (or even by stimulating voluntary saving), we increase the excess of private savings over private investment, reducing the economy's capacity to stand taxation. The result is likely to be a dogmatic reversion to "soundness" at just the wrong time. This seems to the writer a powerful consideration in favor of taxes—particularly of progressive taxes which cut deeply into savings.

INCIDENCE AND "FAIRNESS" OF FORCED LOANS AND TAXES

So far, we have been following the path of monetary analysis, and the ground under our feet has been moderately secure. But really to choose among alternative measures, we must plunge into the quagmire of "incidence" and "distribution of burdens." The difficulties of analysis are greater, if possible, for forced loans than for taxes.

There are three main considerations to be weighed: (1) the immediate levy, viewed as a tax; (2) the present value of the certificate to its recipient; (3) presumable effects on future taxes. The complications, of course, arise from the last two. A levy which would be condemned as an unfair tax may still be fair if the "certificate" sweetens it sufficiently.

With the Keynes Plan proposals, i.e., sweetened taxes on net income in excess of exemptions, the considerations of certificate and future taxes are largely offsetting. The existence of the certificates, as we have seen, means a larger public debt and heavier taxes in the future. The holders of certificates will necessarily be at the margin of federal taxation. Accordingly, the heavier taxes called for by the certificates will be largely upon the certificate-holders and their social equivalents, and the difference from a straight income tax is readily exaggerated. It consists chiefly of this: Forced loans striking savings more and spending less than taxes, the certificate-holders will consume more during the war and less later than if definitive income taxes were levied during the war. This results in an apparent paradox: Forced loans are a device by which high-income groups push their consumption forward in time, that is, borrow from low-income groups!

With social security proposals, we may suppose that the effect upon postwar taxes is second-magnitude, so that the problem is to combine the effects of the present levy and the certificate. In the writer's opinion, the value of future social security benefits to those affected is exaggerated by the sponsors of these proposals. For this suspicion, there are three chief grounds:

1. *Interest rates.* Judging from installment finance, a postponement of consumption is worth well over 10 per cent per annum to a working man.

2. *Price-level hazards.* If our anti-inflation measures prove inadequate, claims on social security will lose value.

3. *Offset of social security and relief.* A large part of the benefits promised under social security could fairly be claimed by the beneficiaries as a charge against general revenues, if social security did not exist.

Pointing in the other direction, there is:

4. *Insurance value of social security.* It may be worth a man's while to pay, for example, \$50 for a 25 per cent chance of collecting \$100, if the \$100 will certainly be available in case he loses his job, and if the odds are merely those of unemployment.

If insurance were never worth more than actuarial value to the insured, obviously, the costs of administering it would be pure social loss. Where the fourth factor is so powerful that social insurance is worth while despite the first three, the need of inflation control may be the decisive consideration. So far as the writer understands the Canadian situation, it appears that Canada was wise to adopt unemployment insurance during 1941; and American schemes for dismissal compensation are promising enough as social insurance to deserve careful consideration. But for most such proposals, the writer's feeling is that the first three factors outweigh the fourth, and that the forced loan certificate must be written down to a small fraction of face value. This leaves the net effect of the proposal uncomfortably close to wage taxes for general revenue—an obnoxious proposal both in form and incidence.

TIMING

To hold inflation within reasonable limits calls for fiscal measures which are not merely powerful, but prompt. One of the great contributions of forced loan advocates to the

general fiscal discussion has been their tendency to urge schemes which will take hold promptly upon spending. But, of course, this is no patent of the forced loan advocates. Prompt collection is part of Professor Lutz's "gross-income-tax" plan, and of most of the other tax plans advocated in recent months by economists; and it underlies the latest major Treasury proposals. By collection at the source and other devices discussed by Dr. Heller in this volume, income taxes can be adjusted to do the monetary business.

The argument presented in the foregoing discussion has indicated many advantages of taxation over forced loans, and of forced loans over taxes. The upshot is that the legitimate field for forced loans of social security pattern is very limited. But as between Keynes Plan loans and income taxes of the sort the Treasury has recently recommended, the economist's margin of choice is narrow. The writer is inclined to favor taxes, in the interests of long-run financial soundness. It may well prove, however, that Keynes Plan loans are more acceptable politically, both because they evade the danger that source-collected income taxes may be regarded as class legislation, and because they help to allay the fear of the demobilization period which keeps arising to plague us in both business and labor circles. If so, the economist who feels that income taxes are the best check on inflation can accept forced loans very cheerfully as a respectable second choice. On the other hand, forced loan advocates should be very well satisfied with income taxes as anti-inflation measures. The economist's responsibility is to see that both the Keynes Plan and income tax proposals get a fair hearing, and, particularly, that differences are not exaggerated and the two plans do not kill each other off.

CHAPTER IX

HOW TO BORROW THE MONEY *

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THE SECRETARY OF THE TREASURY recently estimated that the federal revenue legislation now on the statute books will produce some fourteen billion dollars in receipts during the current fiscal year,¹ and it may be expected that within twelve months the whole tax structure will be revised in such a way as to produce considerably larger sums. But present federal expenditure for nondefense purposes is close to its all-time maximum, and defense expenditure, which is currently at the rate of one and one-quarter billion dollars per month, will soon go to one and one-half billions per month, or even more. Furthermore, it is rumored that the all-out "victory requirements," which government officials are reported to be working on now, will boost the sixty billion dollar defense expenditure, called for under present plans, to one hundred or one hundred and fifty billions; all this to be spent by the end of 1943 or 1944. And these are rates of expenditure, actual or prospective, when the United States is technically at peace. Should an actual war, a shooting war, develop between this

* The material in this paper was developed by the author in connection with work on Fiscal Policy Project B1 of the National Bureau of Economic Research.

¹ Secretary Morgenthau, speaking before the American Bankers' Association, October 2, 1941.

country and the Axis powers, still higher rates of expenditure are certain to follow.

As of August 31, 1941, the total outstanding public debt of the United States was approximately fifty-one billion dollars.² It is not unreasonable to suppose that within the next three or four years the debt of the United States may rise to one hundred and fifty or one hundred and seventy-five billions. Such a figure would equal or exceed the entire amount of debt—federal, state, local, corporate debt in the form of mortgages, consumer credit, and debt owed by individual persons and by unincorporated enterprises—that was outstanding in this country in 1939. As estimated by the Department of Commerce, all forms of debt in 1939 amounted to approximately one hundred and sixty billion dollars,³ and we are now contemplating a federal debt which by itself will equal or surpass that figure.

Furthermore, in order to meet the defense and nondefense expenditures in the years ahead, the sums of money that the Treasury will need over and above tax receipts, large as such sums will be, do not represent the total sums that the Treasury will have to borrow. For, in addition, there is interest that must be paid on the debt; and the existing government bond issues now outstanding that will mature within the next few years will have to be honored, through an exchange of securities, if not through a cash payment. Furthermore, the Treasury recently announced that it plans to refund, through the flotation of its own bonds, the maturing debt of federal agencies guaranteed by the United States. The sums that will be needed for these three purposes during the next four or five years will cer-

² *Bulletin of the Treasury Department*, September, 1941, p. 13.

³ *Survey of Current Business*, June, 1940, pp. 15-16.

tainly average in excess of three and perhaps in excess of four billion dollars per annum.

NEED FOR A BORROWING PROGRAM

Clearly the country is faced with the question of how to borrow the money. For it is evident that within the next few years the United States is going to have to borrow a stupendous sum—perhaps fifty billion dollars, perhaps one hundred billions, perhaps more. The amount that will be necessary so far exceeds the sums borrowed during the first World War or the Great Depression—the two intervals of heavy deficit financing—that the experience gained in those periods has little application for the situation which now confronts the nation.

The public interest requires that the government formulate carefully its plans for borrowing these sums. Such plans should be closely integrated with those designed to increase the tax revenues. Such plans should also be made in terms of social objectives. Possibly the objectives should be what are sometimes vaguely called “long run”; probably the objectives should be designed to aid in the achievement of a desirable form of economy at the end of the present emergency; certainly the plans should be such as to carry the country safely through this current emergency—without serious impairment of the government credit and without a disastrous rise in prices.

The proposals which will be set forth in this discussion are not offered as an economic reform but as an emergency measure. They are not intended to be a comprehensive and all-sufficing program. They are not proposed as an alternative to the present borrowing policies of the Treasury, except in so far as they would reduce the present great, and dangerous reliance of the Treasury on the banking system as the

chief market for government bonds. Nor do they obviate the desirability of some sort of forced savings plan of the type associated with the name of John Maynard Keynes. They do not blink the fact that the sale of bonds, in the volume which apparently will be necessary, constitutes a tremendous merchandising problem; that this problem, in all probability, signifies a large distributing organization; and that such an organization means expense, irrespective of the proportions of paid and volunteer workers which such an organization might contain. The proposals do outline a method whereby it is estimated that at least five billions and perhaps as much as ten billion dollars in government bonds can be sold annually, sold expeditiously, and sold, it is believed, with fewer deleterious effects on the economic structure than is possible under any other method so far made public.

REQUISITES OF A SOUND PROGRAM

The beliefs which form the background for this proposal, and which are, it is thought, the proper criteria on which any sound borrowing program must be based, are presented as an introduction to the proposals themselves.

The debt which will necessarily be created during the next few years should be sold in such a way as to minimize the inflationary tendencies that are inherent in the operation. Specifically, so far as possible, these bonds should not be sold directly to the commercial banks, nor to the Reserve Banks, nor to individual persons who finance their purchases through bank loans. Sales made in these ways necessarily tend to increase the volume of bank credit, and consequently to enhance the danger of inflationary advances in prices. During the first World War the Liberty Loans and the Victory Loan were largely sold "to banks or

through banks"; the volume of bank credit was greatly increased; and the rise in prices, which was thereby partially if not wholly engendered, has subsequently been generally regarded as an economic disaster.

The ownership of the debt which will be created during the next few years should be spread throughout the population as widely as possible. There are a number of reasons for this conclusion, of which two may be mentioned here. First, if the government debt is concentrated in the hands of relatively few holders, such as the commercial banks, the market for government bonds tends to become "vulnerable" in the technical sense, and subject to larger fluctuations than would be the case if the debt were held more widely. The effect of such fluctuations upon subsequent financing is likely to be unfortunate. Second, if some portion of the economic mechanism, such as the banks or the insurance companies, becomes heavily "overloaded" with government bonds, that section of the mechanism, to greater or less degree, loses its freedom of action and its ability to perform what is ordinarily considered its proper function in the economic process. Should there be, as many persons anticipate, serious economic dislocations at the end of the defense emergency, the fact that important economic institutions are unable to play their usual and proper part in society may easily make these dislocations more severe than would otherwise be the case. Certainly, it would not seem to be in the public interest so to distribute the public debt as seriously to impair the usefulness of the banking system, or in such a way as to convert the banks into mere depositories for government bonds.

In so far as possible, the bonds which will be sold during the next few years should be sold in such a way as to restrict the expansion of credit not needed to support the

defense effort. Again, there are a number of reasons for this decision, of which two may be mentioned here. First, the defense effort gives many indications of needing all the credit available for its support. Second, the greater the expansion of credit, especially of credit outside the defense effort, the greater may be the effect of those inflationary tendencies inherent in any expansion of credit. The operations of the Capital Issues Committee of the first World War and the similar measures instituted at the same time were undertaken in order to restrict the flow of capital elsewhere than into the war effort; and the reasoning that lay behind those measures appears to be entirely valid today.

The methods and policies employed in the sale of bonds during the next few years should be such as to minimize the administrative difficulties that will in any event be encountered in the operation. No matter how sound on theoretical grounds a program of deficit financing may be, if it is not administratively feasible, it will defeat itself.

The achievement of the objectives just outlined would be greatly facilitated, if substantial portions of the federal securities floated during the next few years were sold in such a way, or on such terms, as to restrict or prevent, at least during the emergency, the resale of these securities by the original buyers. Likewise, the achievement of these objectives would be aided if substantial portions of the securities issued during the next few years were sold in such a way, or on such terms, as to limit or prevent their use as collateral for bank loans. For nonnegotiable bonds cannot come into the market, either in response to, or in order to influence, the sometimes irresponsible forces of demand and supply that moment by moment determine the quotations for government bonds; and bonds that cannot be used as security for bank loans do not so readily afford a base

for an expansion of bank credit as do bonds that can easily be used as collateral. The issues of government securities sold direct to government accounts and trust funds, the various types of defense bonds now on sale, and the tax anticipation certificates recently introduced, are all mechanisms for making a portion of the government debt impervious to market forces. But it is very doubtful if these outlets for government obligations will remove and insulate from the market, during the next years ahead, as large a portion of the debt as in the public interest should be so removed.

Finally, the bonds which will be sold during the next few years should, if possible, be sold in such a way as to stimulate the rate of savings in the community, in order to expand the volume of funds available for the purchase of government securities. The desirability of this increased flow of savings, of course, depends on the assumption that these larger savings will in fact be invested in such securities. Not only would a larger flow of savings increase the volume of resources at the disposal of the government, but it would also have a distinctly deflationary effect on the price level. For funds diverted from consumption purposes and turned over to the government reduce, at least until such time as they are spent by the government, the volume of buying power which, when offered in the markets for food, clothes, and services, tends to push up the prices of these items.

FUNDS AT WHICH THE PROPOSAL IS DIRECTED

In this discussion, savings are defined as those portions of realized cash receipts of persons, business firms, trust funds, states, and municipal corporations, and eleemosynary institutions that are not expended in the following ways:

in the case of persons, for consumption purposes; in the case of business firms, trust funds, municipal corporations, and eleemosynary institutions, as operating expenses and depreciation charges; in the case of business firms and trust funds, as interest or dividend payments or as entrepreneurial withdrawals; in the case of persons, business firms, trust funds, municipal corporations, and eleemosynary institutions, as donations, or in the payment of taxes. Funds diverted from such purposes are available for investment, although so long as they are held by the owners as balances, either in the form of cash or as bank deposits, they are not invested. In view of the definition of savings employed here, these sums can be invested by the owner only in two ways: through the acquisition of a new asset, an asset not previously owned, either personal or real, such as a house, plant and equipment, a bond, a stock, or a mortgage; or through the repayment of the debts of the owner of the funds.

This discussion is not concerned with those funds available for investment which the owner intends to use or does use in the acquisition of a new asset.⁴ The discussion is directly concerned with funds destined and used by debtors for the repayment of debts. Debts, as the term is here used, include all indebtedness of state and local governments, all corporate indebtedness, all mortgage indebtedness of individuals, all indebtedness to banks, all so-called

⁴ Presumably funds destined for the acquisition of new assets, such as securities, can be tapped by the government in a variety of ways in the sale of its securities. Presumably the use of funds destined for the acquisition of new physical assets, such as houses or plant and equipment, will be controlled through the administration of allocations and priorities. In those instances where funds have been intended for the acquisition of new tangible assets and where shortages and priorities prevent their use in the intended manner, at least some portion of the funds will become available to the government as a market for its securities.

consumer credit, and all policy loans of life insurance companies.

THE PROPOSAL

The proposal is as follows: All creditors under existing contracts and under all future contracts made during the emergency, where the individual debt amounts to \$300 or more, shall be required by law, as they receive repayments, to set aside a stipulated portion of each payment, say 20 per cent. The creditor shall further be required to invest this stipulated portion in government bonds; such bonds shall be registered or otherwise placed in the name of the *debtor*. The debtor shall then be required to place these bonds in escrow for the benefit of the creditor until such time as his total debt to the creditor shall have been satisfied in full. The debt which is owed to the creditor will be reduced under this proposal, not by the total payment that the debtor makes to the creditor, but only by that portion of the payment which the creditor is *not* required to invest in government bonds—in the example used here, by 80 per cent of each payment.⁵

For instance, if under a mortgage agreement with a bank a debtor owes on his debt in any given year \$1,000, and he pays this sum to the bank, the bank would be required to receive the \$1,000, to reduce the debtor's total indebtedness by \$800, and with the remaining \$200 to buy government

⁵In order to simplify the exposition, the same percentage of debt repayments, 20 per cent, as regards all types of indebtedness in the discussion, is required to be invested in government bonds. If this or a similar proposal were put into operation, it would be necessary to reduce the rate applied to such loans as those made to business concerns for working capital purposes, to, perhaps, 5 per cent. It might well be desirable to increase the rate applied to other types of debt, such as personal debt or mortgage debt, to, perhaps, 40 or 50 per cent. Variations as between different types of debt in the percentage of repayments required to be invested in government bonds is entirely in accord with the spirit and the objectives of this proposal.

bonds which would be placed in the debtor's name. The debtor would then be required to place these bonds in escrow for the benefit of the bank until such time as his entire debt under the mortgage was satisfied. In the case of corporate debtors, the trustee would be the person required by the statute to act. He would be required to act irrespective of whether the sums paid him were to be used in direct retirement of outstanding bonds, or for accumulation in a sinking fund.

The arguments in favor of this bond-sale-through-debt-repayment plan can be summarized as follows: It would create a new and a very large market for federal securities, a market which, it is estimated, could absorb between five and ten billion dollars of securities annually.⁶ This market would be relatively steady from year to year, and not dependent on the somewhat haphazard forces of the market place that from time to time affect government credit. The creation of this market would disturb very little the existing financial mechanism and existing financial contracts. The necessary legislation would be of a sort which could be repealed at the end of the emergency with little or no damage to the economic system. The administrative difficulties inherent in establishing and maintaining this market would be less than those inherent in establishing and maintaining a market of equal size created in any other

⁶ The extent to which the market for government bonds created by this proposal would be "new," in the sense of being "additional" to all existing markets, depends upon the assumptions made as regards the behavior during the war of a large number of factors. Among these factors are: the proclivity of individuals and institutions to save and to invest in government bonds; the proclivity of creditors to convert their assets into government bonds; the demand for credit, both long-term and short-term, by both defense and nondefense industry; the policies pursued by federal lending agencies. The assumptions that currently appear most likely of fulfillment suggest that a major portion of the market created by this proposal would be "new" in the sense of being "additional."

way. This market would not infringe upon, or be dependent upon, other markets, since the securities sold in it would not require that the buyers first liquidate assets in order to acquire funds with which to buy bonds. The inflationary dangers that are inherent in borrowing sums, as large as those which will be needed, would be minimized under this proposal. The debt would be widely distributed, not concentrated in a few hands. The volume of saving would be stimulated, because debtors, in order to extinguish their debts, would either be forced to save at the rate called for in their original contracts but for a longer period than they had contemplated, or they would have to save at a more rapid rate than they had anticipated, if they wished to repay their debts within the period contemplated at the time they assumed the liability. But this additional saving imposed on debtors would not be a severe burden, since they would regain full control over their additional savings as soon as they paid their debts. Creditors might have to wait somewhat longer for full repayment of their claims. This burden, however, would not be severe, since debtors would be required to accumulate and hold a gilt-edged asset to the full amount of the postponed repayments; and the debtors would not be able to dispose of this asset until they had satisfied their creditors in full. Finally, extensions of credit made subsequent to the enactment of this proposal would be made with greater circumspection, for both creditors and debtors would know that the debtor would be required to save more than 100 per cent of his obligation in order to extinguish his liability.

ESTIMATES

There follow estimates of the amount of government bonds which could be sold if this proposal were adopted:

The gross debt of state and local governments in the United States as of 1940 has been estimated at \$20,225,000,000.⁷ Suppose as much as one-quarter of this amount is held in sinking funds or in trust accounts of the issuing state or municipality, the net debt figure would then amount to about \$15,056,000,000, a figure that closely corresponds with the estimate of \$15,583,000,000 made by the Department of Commerce for net state and local debt existing as of 1939.⁸ It is certainly reasonable to assume that annually at least 5 per cent of \$15,000,000,000, namely, \$750,000,000, either is retired, or through a sinking fund arrangement has provision made for its retirement. If 20 per cent of such a sum were invested annually in government bonds, a market would thereby be created that each year would absorb \$150,000,000 of federal securities.

As of 1939, the gross long-term corporate debt in the country was estimated by the Department of Commerce to be \$76,000,000,000, and the net long-term corporate debt to be \$49,400,000,000.⁹ Neither of these figures is just what is needed for the computations of this study; what is needed is a figure that lies between these two extremes, a figure for gross debt less securities held in sinking funds but not reduced—as is the net figure of the Department of Commerce—by deductions of the debt of a holding company and/or its subsidiaries held within the corporate system. Let us say that the figure needed is approximately \$65,000,000,000. It is conservative to estimate that at least 5 per cent of this amount, \$3,250,000,000, is annually retired or has provision made for its retirement. Were 20 per cent of the sums used for these purposes invested in government

⁷ The Tax Foundation, *Tax Facts and Figures*, p. 66.

⁸ *Survey of Current Business*, June, 1940, p. 15.

⁹ *Ibid.*, p. 16.

bonds, a market that would each year absorb \$650,000,000 of such securities would thereby be created.

As of 1939, the Department of Commerce estimated that the total amount of real estate mortgage debt outstanding, including both farm and urban property, was approximately \$33,000,000,000.¹⁰ It is quite likely that at least 8 per cent of this amount, \$2,640,000,000, either is repaid each year or has provision made for its retirement. Should 20 per cent of the sums used for such repayments be invested annually in government bonds, a market would be created that each year would absorb some \$528,000,000.

As of December 31, 1940, the outstanding loans of all banks in the United States amounted to \$23,740,000,000.¹¹ If it is assumed that 20 per cent of such loans were real estate loans,¹² and hence have been included in the previous estimates of mortgage debt, then 80 per cent of this figure, or approximately \$19,000,000,000 can properly be used in these calculations. Presumably the larger portion of this amount is repaid during any twelve-month period, and re-loaned and repaid again, at least once, and perhaps two or three times. In order to be conservative, however, let us assume that this sum is repaid only once during the year; then the figure to use in these calculations is 20 per cent of \$19,000,000,000. Should 20 per cent of this estimated amount of repayments be annually invested in federal obligations, a market for such securities would be created that each year would absorb some \$3,800,000,000 of these securities.¹³

¹⁰ *Ibid.*, p. 15.

¹¹ *Federal Reserve Bulletin*, July, 1941, p. 684.

¹² The loans of member banks, which amounted to about two-thirds of the loans of all banks at this date, included real estate loans to approximately 21 per cent of their total.

¹³ One of the criteria earlier set up for a proper borrowing policy was that it should prevent bonds from quickly coming back on the market,

The Department of Commerce has estimated that at the end of 1940, consumer credit outstanding amounted to some \$5,039,000,000.¹⁴ Some \$581,000,000 of this amount was extended by commercial banks, and has already been included in the estimate of bank indebtedness. When this amount is deducted from the total, there is left the sum of \$4,459,000,000. If it is assumed that half of this amount is made up of individual loans, each of less than \$300 in amount, there is left the sum of \$2,230,000,000 that can properly be used in these computations. The Department of Commerce estimated that three-fourths of the volume of consumer credit outstanding at any time will ordinarily be repaid within twelve months. Three-fourths of \$2,230,000,000 amounts to \$1,673,000,000. Should 20 per cent of such repayments be invested in government bonds, a market would be created that annually would absorb \$335,000,000 of such securities.¹⁵

At the end of 1938, the loans to policy holders of 240 American life insurance companies and 66 industrial life insurance companies amounted to \$3,225,000,000.¹⁶ If it is assumed that one-half of this amount is made up of individual loans of less than \$300, then one-half of this sum, or \$1,613,000,000, is the sum to use in these computations.

and also that it should, at least for a period, prevent the bonds being used as collateral for loans. Clearly, the proposal here set forth would not operate in such a way as to meet this criterion in the case of short-term debt. But if it were stipulated as regards short-term debt that some or all of the required percentage of debt repayments used to purchase federal securities should be invested in bonds characterized by limited negotiability, such as defense bonds, this criterion could very readily be met.

¹⁴ *Survey of Current Business*, September, 1941, p. 10. Consumer credit was there defined as "installment consumer debt—credit normally extended for a period longer than 3 months for purchasing goods at retail and which is repayable on a deferred payment basis."

¹⁵ The content of footnote 13 is as applicable to consumer credit as it is to commercial bank loans.

¹⁶ *Insurance Year Book*, 1939, "Life Insurance," p. 136a.

It is reasonable to assume that at least 10 per cent of this amount, or \$161,000,000, is repaid annually. Should 20 per cent of such repayments be invested in government securities, a market would be created that would absorb annually \$32,000,000 of such obligations.

TABLE 1

ESTIMATED DEBT OUTSTANDING IN THE UNITED STATES OTHER THAN FEDERAL; ESTIMATED ANNUAL RETIREMENT OF DEBT; PROPORTION OF SUCH RETIREMENTS THAT COULD BE USED TO PURCHASE FEDERAL GOVERNMENT BONDS

(In Millions)

Type of Debt	Estimated Amount Outstanding	Estimated Percentage Repaid Annually ^a	Estimated Dollar Amount Repaid Annually ^a	Percentage of Retirements Proposed To Be Used in the Purchase of Government Bonds	Market for Government Bonds Created by This Proposal
State and local.....	\$ 15,000	5	\$ 750	20	\$ 150
Long term corporate	65,000	5	3,250	20	650
Farm and urban mortgages.....	33,000	8	2,640	20	528
Commercial loans of all banks ^b	19,000	100	19,000	20	3,800
Consumer credit ^c ...	2,230	75	1,673	20	335
Insurance company loans to policy holders ^d	1,613	10	161	20	32
Total.....	\$135,843		\$27,474		\$5,495

^a "Repaid" includes both repayments and provision for repayments.

^b Adjusted to eliminate real estate loans.

^c Adjusted to eliminate credit extended by commercial banks and individual loans that are less than \$300 in amount.

^d Adjusted to eliminate individual loans that are less than \$300 in amount.

Under the assumptions made, this proposal would create a market for government bonds that would annually absorb at least \$5,500,000,000 of such securities. Conceivably, much larger amounts might be absorbed. In the

accompanying table are the computations on which this estimate is based. Were the percentage of debt repayments used to purchase government bonds reduced below the 20 per cent level that has been employed in this discussion, the market would be correspondingly reduced; were the percentage of debt repayments invested in government bonds raised above the 20 per cent figure, the market would be correspondingly increased.

CHAPTER X

BORROWING AND INFLATION

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IN SO FAR as inflation is to be controlled through revenue policies, there can be little doubt that the most effective measures of control are tax measures. Whether we choose to employ income and social security taxes collected at the source at the time income is received, or sales taxes levied at the time it is spent, we accomplish essentially the same end. A portion of the money income stream is drawn off from the market for consumers' goods before it is made available to the government for expenditure in the production of defense goods. Since, in the process of being thus spent, most of this money will find its way back into the pockets of consumers, these tax withdrawals serve to prevent an expanding stream of consumer purchasing power from raising the prices of consumers' goods, at a time when the supply of such goods cannot be equally expanded.

But even though it is generally agreed that, of all revenue policies, tax policies offer the most effective means of controlling inflation at a time like the present, we must recognize that there are limits to the speed with which new tax measures can be enacted. The fact that no major war has probably ever been fought on a strictly pay-as-you-go basis cannot be explained solely in terms of an

absence of foresight, or a want of courage or resolution on the part of political leaders. Aside from the natural resistance of the taxpayers themselves to the imposition of additional levies upon them, it is common knowledge that the inequities which are inherent in most taxes tend to become magnified as the demands upon them are increased. Nor can we ignore the effects of sudden increases in tax burdens on the willingness of individuals to contribute freely to the defense or war effort. If the stimulation of economic rewards is necessary for the maximization of the nation's productivity, public policy may be best served by not attempting to tax away too large a fraction of these rewards too suddenly.

The volume of federal spending called for under the defense program was so large that, from the start, it was apparent that the government would have to make a considerable use of borrowed funds. With defense expenditures alone rising from an actual \$1,600,000,000, during the fiscal year 1940, to an estimated \$18,000,000,000, for the current fiscal year, a pay-as-you-go policy was out of the question. The most that we were prepared to do was to finance two-thirds of our expenditures with tax receipts, and to borrow the remaining third. While in thus committing ourselves to the use of borrowed funds, we were definitely increasing the risk of inflation, we did not necessarily forfeit our chances of controlling inflation through revenue policies. For a borrowing program may be carried out in a number of ways, some of which tend to maximize and some to minimize the risk of inflation. It is with these alternatives, and with the extent to which each of them seems capable of being exploited at the present time, that we shall be concerned in this paper.

THE INFLATIONARY POTENTIAL IN PRESENT FISCAL PROGRAM

Whether a loan-financed defense program is or is not likely to lead to inflation, depends largely on what kind of money it is that the government borrows and spends. Before attempting to elaborate on this statement, it may be well to see first what it means. Inflation we shall take to mean a rise in the cost of living, or a rise in the prices of those goods on which consumers spend their money incomes.

In referring to the kinds of money which the government borrows and spends, we have in mind a somewhat different classification from those which are usually found in discussions of money. In one of these more familiar classifications, money is said to consist of (1) notes and coins in circulation, and (2) checking deposits in banks. At the present time, this stock of money consists of some 10 billion dollars of notes and coins, and of some 41 billion dollars of deposits.

At any given time, every dollar of this money may be regarded as being in the possession of, or as being credited to the bank account of, some person, corporation, or government. We may also think of each of these parties as having made at least tentative plans with respect to the disposition of this money. In terms of such plans, it will then be possible to say that the additional money which the government borrows to finance the defense program (1) is money that would have been spent on consumption goods, (2) is money that would have been saved and invested in non-money assets other than government bonds, or (3) is money that would have been hoarded or held idle.

Here, then, we have three kinds of money that the gov-

ernment may borrow, but there is still a fourth—new money, or money that would not have existed at all if the government had not borrowed. The government can, of course, borrow new money only when it borrows from the commercial banks, since these institutions alone, among the buyers of government securities, have the power to create new money. It is for this reason that the purchase of government bonds by commercial banks may be of considerable monetary significance.

We can now restate the proposition advanced earlier. Whether a loan-financed defense program is or is not likely to lead to a rise in the cost of living, depends largely on whether the government borrows money that otherwise would have been spent, money that otherwise would have been saved, or new money. We shall find, in our subsequent discussion, that to the extent that the government borrows money that otherwise would have been spent or saved, the risk of inflation is minimized; and that to the extent that the government borrows new money, this risk is maximized. The inflationary potential in the government's fiscal program can, therefore, be estimated in terms of the difference between the amount of money which the government must borrow and the amount it can borrow from non-inflationary sources.

During the course of a year, the aggregate amount of money funds which individuals and corporations decide to spend, or to save, will be equal to the national money income less the taxes which they are compelled to pay to different governmental units. So long as the government is able to satisfy its need for loan funds by tapping this stream of current money income, it will not have to borrow newly created bank money. But if the government's need for such funds continuously exceeds the amounts which in-

dividuals and corporations are willing to lend to it out of current income, the difference will have to be borrowed in the form of new money if it is borrowed at all. Therefore, the extent to which the government can practice non-inflationary borrowing depends upon the level of the national money income, and upon the extent to which the recipients of income can be persuaded to refrain from carrying out their plans for spending and investing it.

LOANS—A VOLUNTARY REDUCTION IN PURCHASING POWER

In so far as the government is able to borrow money that would otherwise have been spent on consumers' goods, the risk of inflation is minimized. In this case, the money which the government puts into the hands of the defense workers, and with which it increases their purchasing power, is money that has come out of the pockets or bank accounts of consumers. But if these consumers would have spent this money themselves, had they not been persuaded to buy the bonds instead, it is evident that the spending of this money by the government cannot increase consumer purchasing power in the aggregate, and so cannot lead to a rise in the prices of consumers' goods. What the government has put into the consumers' income stream at one point, it has taken out at another. This, then, is clearly the least risky kind of money for the government to borrow, if inflation is to be avoided; but it may not be the easiest kind to borrow. Let us see what is involved.

For one thing, the government must be able to persuade the individual recipients of money income that they should reduce the proportion of current income that they had planned to spend in the satisfaction of their immediate wants. Since most persons have fairly well-established patterns of saving and spending, it may not be easy to

induce them to change their practices. Although the government can offer them a high degree of security for their money, it does not offer them a very high return. Specifically, at best it can offer twenty-five dollars worth of purchasing power ten years from now in exchange for eighteen dollars and seventy-five cents of present purchasing power. This is not an unattractive rate of return for those who had already made up their minds to save, but in itself it is hardly likely to stimulate much new saving. The government must, therefore, rely mainly on an appeal to the patriotism of the bond purchasers, if it hopes to attract much money that otherwise would have been spent.

To some extent, the success of a loan program in attracting money of this kind will be influenced by other governmental policies. If the government is increasing taxes at the same time that it is asking individuals to buy bonds, persons in the low- and middle-income classes may find that they have had to cut their spending so sharply in order to meet heavier taxes that they cannot consider making still further voluntary reductions in current consumption. On the other hand, if priorities or high excise taxes cut down both the supply of, and the demand for, certain kinds of durable consumers' goods, some individuals, who find themselves forced to postpone the purchases of those goods, may prefer to put this money into government bonds rather than spend it on other consumers' goods. We cannot overlook the possibility, however, that the very prospect of future shortages may be causing people to spend more rather than less of their current incomes, in an attempt to anticipate those wants which they fear they will not be able to satisfy later on.

It has been suggested that the government might be able to persuade more people to reduce their spending in order

to buy defense bonds, if it offered them higher rates of interest. We have no way of knowing how much of a response could be expected to an offer of five per cent, or even of ten per cent, instead of the current two and one-half to three per cent; but if it is true that the short-run supply of saving is fairly inelastic, an experiment of this kind might accomplish little more than an increase in the interest charges on the public debt. Certainly, all of the present holders of defense bonds would find it to their advantage to redeem these low-yield securities in order to buy the new high-yield ones.

Furthermore, even if higher interest rates on bonds sold to individuals did enable the government to borrow larger amounts of money that otherwise would have been spent, it is possible that the money borrowed would not be money that would have been spent on those consumers' goods which the defense workers would want to buy, but would be money that would have been spent on luxury goods which only the upper income classes could afford. From the point of view of controlling inflation, it is questionable whether the government should offer a high premium for the reduction in expenditures of this kind.

GOVERNMENT USE OF INACTIVE MONEY

The second kind of money which the government may borrow is money that would have been saved and invested in earning or interest-bearing assets other than government bonds. In this case, the money which the government puts into the hands of the defense workers is again money that would have come out of somebody's pocket or bank account; but it is not money that would have been spent on consumers' goods. Therefore, it is evident that to the extent that we finance the defense program with

this kind of money, we may find it more difficult to prevent the prices of consumers' goods from rising; for the money which the defense workers will spend on such goods will be in addition to the money that was already being spent upon them. Even though we might expect a temporary rise in the prices of such goods, however, borrowing operations of this kind are not likely to bring about sustained price rises, since the increase in the monetary demand for consumers' goods must be accompanied by a decrease in the monetary demand for producers' goods. What we can expect is a shift from the production of nondefense producers' goods to the production of either defense goods or consumers' goods. When these shifts have taken place, the prices of consumers' goods should return to approximately their former level.

On the other hand, if the money borrowed by the government is money that would have been saved and hoarded, we may expect such borrowing to have little if any effect upon the prices of consumers' goods. In fact, if the government had not persuaded the prospective hoarder to buy its bonds, the aggregate monetary demand for goods would have fallen. For although the act of holding a larger part of one's current money income idle, does not reduce the stock of money outstanding, it does reduce the amount of such money in active circulation. During the years of depression, it was in borrowing money of this kind that the government could make its greatest fiscal contribution to recovery. But the situation in this respect is quite different during years of heavy defense or war expenditures. At such times, one of the objectives of government borrowing is to reduce consumer spending; but if some consumers reduce their spending by holding some of their money income idle, the fact that the government borrows

this money that otherwise would have been hoarded cannot further reduce such spending.

When the government borrows money that otherwise would have been held idle, it may have only forestalled an act of hoarding in the manner described above; but, on the other hand, it may have brought about an act of dis-hoarding. In the former case, the sale of government securities merely prevented a part of the active money supply from becoming inactive; in the latter one, however, the sale of these securities would make a part of the inactive money supply active once more. Since an increase in the supply of active money is equivalent to an increase in the monetary demand for goods and services, it is clear that to the extent that the government draws its funds from previously accumulated idle balances, loan financing is likely to have inflationary effects.

At the present time, the volume of inactive money appears to be very high. Professor Angell estimates that such funds amounted to between 13 and 14 billion dollars, in 1939, and he believes that they are still larger now.¹ Such funds obviously constitute a serious potential threat to any attempt to control inflation through revenue policies; but the danger lies, not so much in the extent to which the government directly activates these hoards by drawing on them, as in the extent to which it might indirectly activate them through its general fiscal policies. What is to be feared is any widespread attempt to convert these money hoards into goods, such as might follow a conviction that the value of money was about to fall very sharply.

Let us next consider the extent to which the government can expect to increase its borrowings of money that would otherwise have been saved and invested. In this case, it

¹ James W. Angell, *Investment and Business Cycles*, pp. 338-39.

is necessary that the government should be able to divert to its own uses a larger proportion of the funds which individuals and business concerns save out of current income. The fact that the tremendous volume of defense spending has brought about a sharp increase in the national income should have made it easier for the government to borrow, for a higher national income usually means a larger volume of saving. But the government still has to persuade investors that they should purchase government securities in preference to other securities or capital assets.

There are three major classes of investors with which the government will have to deal, namely, individuals, business corporations, and financial institutions. Its ability to interest individual investors will depend partly on the investment psychology of the individual saver and the extent to which his investment policy is already determined by past contracts, and partly on the character of the alternative investment opportunities. At their present yields, the marketable issues of government securities are not likely to attract many individual buyers, although the response to the offers of United States savings bonds and the more recent defense savings bonds has been somewhat more encouraging. Individual owners held about four billion dollars of these special issues at the end of June, 1941,² and from June to October, the total sales of defense savings bonds averaged \$277,000,000 a month.³ This would be equivalent to an annual rate of \$3,300,000,000.

Institutional investors have purchased large amounts of government securities in recent years; but the prospects of their being able to continue to make purchases on this scale are uncertain. Over the last five years, the insurance com-

² *Federal Reserve Bulletin*, November, 1941, p. 1165.

³ *Ibid.*, p. 1081.

panies have purchased on the average more than 500 million dollars of government securities a year,⁴ a sum which represents roughly one-third of the annual increment in their assets. Even though higher taxes on individual incomes should cut into their sales of new policies, they could increase their purchases of government securities substantially. Yet the effect which such a policy would have upon their earnings is quite obvious. It may, therefore, be doubted if these companies can be expected to increase the existing high percentage of government securities to total assets.

Over the last five years, the mutual savings banks have averaged a little less than 300 million dollars a year in their purchases of government securities. These institutions, however, are likely to feel the effects of government competition for the funds of small savers. The more the government pushes its savings and defense bonds, the more difficult it will be for the savings banks to attract new deposits. Moreover, the larger the proportion of their assets taking the form of government securities, the harder it will be for them to offer their depositors a rate of interest that will compare with that offered by the government. The commercial banks are in much the same position with respect to their time deposits. On the other hand, the government can still look to its own pension and trust funds for a continuing, if not an expanding, source of loan funds. During the past five years, the government security holdings of federal agencies and trust funds have increased by more than a billion dollars a year.⁵

Finally, business enterprises may serve as at least a temporary source of borrowed funds. The funds which busi-

⁴ *Ibid.*, p. 1165.

⁵ *Ibid.*, p. 1165.

ness corporations might invest in government securities are of two sorts. First, there are the undistributed earnings, or net savings; and second, there are the gross savings which take the form of depreciation and depletion reserves. There are reasons for believing that both the net and gross savings of business corporations may provide the government with a substantial amount of funds during the next few years. For one thing, those defense industries, which must face the necessity of readapting their plants for peacetime production at the end of the present emergency, will presumably both take a high rate of depreciation on their equipment used in defense production, and also hold back some of their current earnings. Such funds might well find their way into the government bond market.

On the other hand, nondefense industries may find it difficult to spend much of their depreciation reserves on replacements of old equipment as a result of priorities. They, too, may have excess cash funds which can be invested in government bonds for the duration of the emergency.

EXPANSION OF BANK CREDIT

The third kind of money which the government may borrow is, as we have seen earlier, money that would not have otherwise existed at all. In this case, the money which the government puts into the hands of the defense workers is not money that has come out of somebody's pocket or bank account; it is money which the commercial banks have created for the use of the government. Therefore, it is a net addition to the aggregate stock of money, and when it is paid out to defense workers, it will also be a net addition to consumer purchasing power. The risk of inflation will clearly be maximized if the government at-

tempts to finance a substantial part of its defense expenditures with money of this kind.

The government may borrow money that otherwise would not have existed, even in cases where it does not borrow directly from the banks. Individuals' purchases of government bonds with funds borrowed from the banks may also be said to have been made with new money, and so are also likely to lead to inflation. During the last war, a considerable percentage of the bonds sold to individuals were financed in this way; but steps have already been taken to prevent a repetition of this practice. The new defense bonds cannot be used as loan collateral, and hence cannot serve as a basis for the expansion of bank credit.

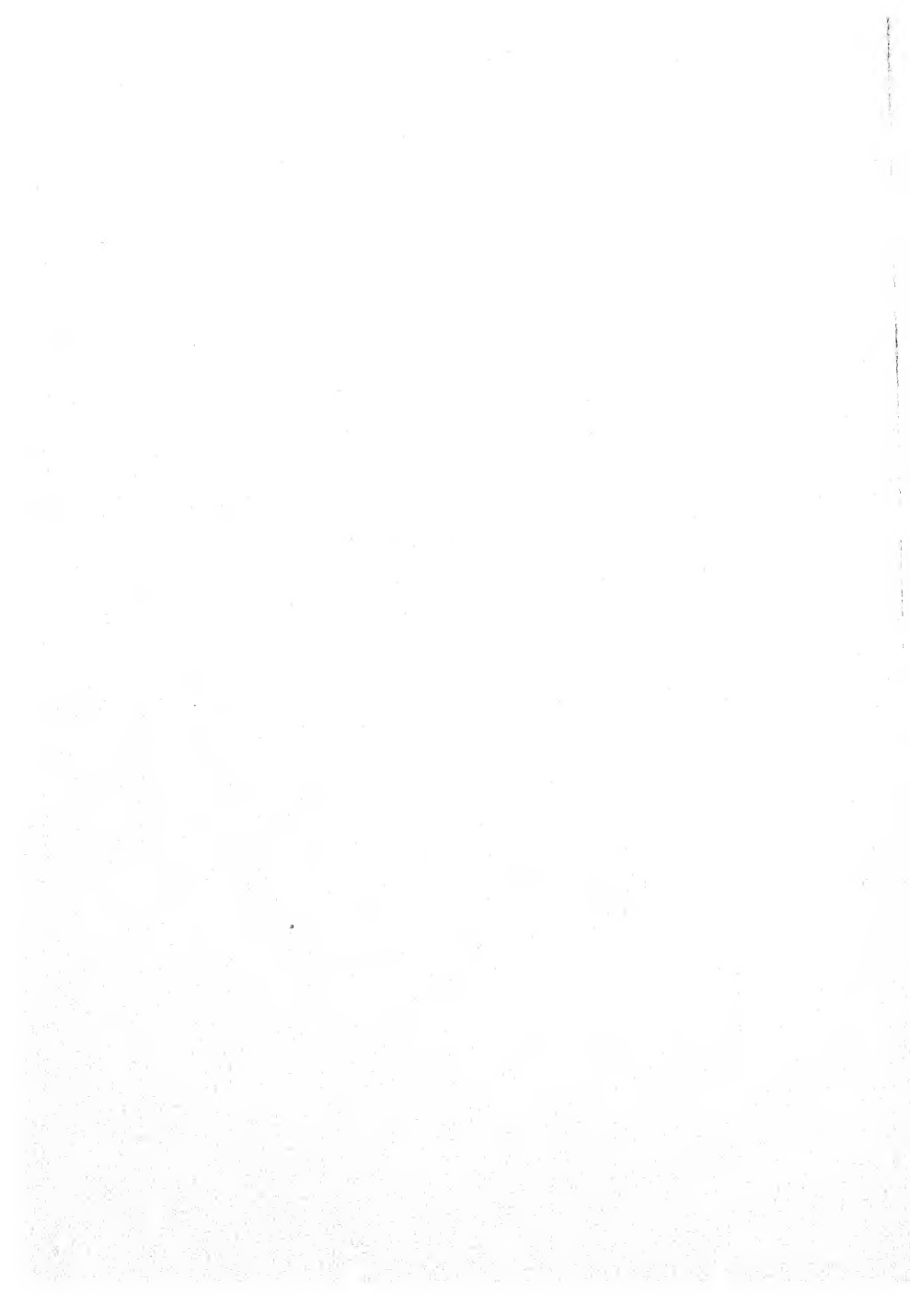
During the last decade, commercial banks have been heavy purchasers of government securities. The holdings of the member banks alone rose from less than four billion dollars in June, 1929, to more than eighteen billion in September, 1941.⁶ Most of this rise took place during the depression years when the banks were confronted with a steady decline in the demand for commercial loans; but nearly five billion dollars of these securities have been purchased since June, 1939. These purchases contributed to the sharp rise in adjusted demand deposits of from seventeen to thirty-two billion dollars, over the twelve-year period. Up to the present time, this increase in the stock of circulating money has been only mildly inflationary, partly because a considerable part of it has been held idle, and partly because the increase in consumer purchasing power has been closely matched by increases in consumers' goods. With the rapid approach to the limit of our ca-

⁶ *Ibid.*, p. 1156.

capacity to further increase the production of such goods, the risk of inflation becomes greater.

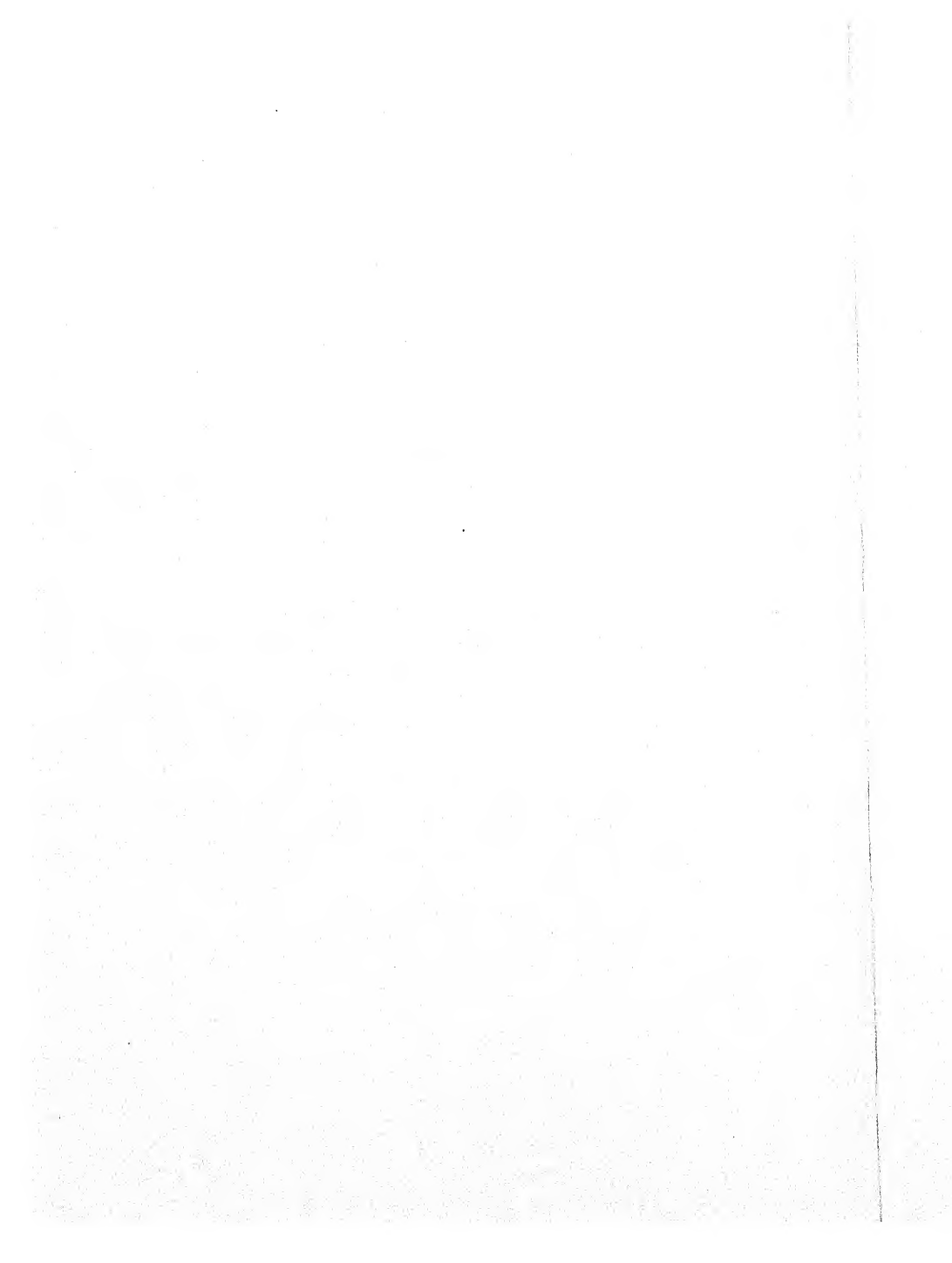
There can be no question of the ability of the commercial banks to expand their deposits further through the purchase of government securities. With the excess reserves of the member banks now at a figure of about three and a half billion dollars, and with the Board of Governors of the Federal Reserve System unable to increase further the reserve requirements under the existing statutes, it would be possible for the commercial banks to expand their government bond holdings by approximately nineteen billion dollars. If deposits of this magnitude were to be added to the existing stocks of circulating money, over the next few years, we should hardly be able to escape a considerable rise in the cost of living.

Whether the banks or the government will be willing to permit an increase to this extent in bank deposits, is another matter. The use that will be made of bank credit in financing the war will largely depend upon the degree of restraint that both the banks and the government can exercise during the war period. Above all, this means that the government must avoid putting itself in a position where it *has* to make use of such credit.



PART FOUR

**ADJUSTMENTS IN EASING IMPACT OF
DEFENSE TAXES**



CHAPTER XI

COLLECTION METHODS APPROPRIATE TO THE WARTIME USE OF INCOME TAXES *

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PRESIDENT ROOSEVELT last month underscored the urgent need for heavier taxes to cut civilian consumption with the following words:

Inflation is itself a most inequitable type of taxation. It grants no exemptions and recognizes no hardships—though a well-drafted tax bill can do both. I very much fear that unless we start within two or three months to withdraw through taxes a larger part of the current national income, an even greater part may evaporate through inflation. . . .¹

Had the President added that the withdrawal of purchasing power must apply even to the rank and file of small-income recipients, whose sheer numbers prohibit their exemption from an anti-inflationary tax, his statement could serve as a summation of the goal towards which wartime income taxes² should be directed.

Acceptance of this appraisal converts the immediate problem of income taxation into one of social engineering,

* Acknowledgment is due the Social Science Research Council for the grant which made possible first-hand observation of collection-at-source systems in the United States and Canada.

¹ The quoted statement is an excerpt from a letter of November 8, 1941, from President Roosevelt to Chairman Doughton of the House Ways and Means Committee. *The New York Times*, November 11, 1941, p. 14.

² Unless the contrary is obvious from the context, the term, "income taxation," as used in this paper includes forced loans based on income.

of devising techniques and methods which will enable income taxes to perform the functions blocked out for them by economic analysis. Investigation of these techniques and methods—their potential contribution, previous American experience in their use, and their incorporation into a workable plan—is the objective of the ensuing discussion.

THE POTENTIAL CONTRIBUTION OF COLLECTION METHODS

Techniques of collection play a vital role both in facilitating the downward and outward extension of income taxes and in reinforcing the anti-inflationary effects of such extension. On one hand, such techniques are the limiting strategic factor which must be manipulated to dissolve the barriers to heavy taxation of low-bracket incomes. On the other, they offer a positive contribution to the efficacy of income taxes as an instrument for timely reduction of consumer purchasing power.³

Facilitating a Broadened Base and Heavier Rates

To be successful in facilitating further broadening of the federal income tax base,⁴ a collection system must (1) collect taxes at a cost which absorbs only a small part of incremental revenue; (2) minimize the loss of revenue through evasion; and (3) promote public acceptance of new and enlarged tax liabilities. Needless to say, if widespread public resistance develops, the first two require-

³ Emphasis throughout this discussion is on specific methods of collection appropriate to increased taxes on a broadened base. One should not, however, overlook the promise of reduced costs and minimized taxpayer irritation inherent in a consolidation of federal and state income tax administrations and returns.

⁴ It is not unrealistic to speak of further broadening of the base in view of (1) current proposals emanating from Washington for reduction of exemptions to \$1,000 for married persons, \$500 for single persons, and \$300 for dependents, and (2) the application of British income taxes to incomes above \$622 for married persons and \$440 for single persons.

ments will be most difficult to meet. It is of crucial importance that collection methods be so devised as to ease the impact on the taxpayer and thereby to lighten the task of administration.

Compulsory Tax-Budgeting

By stimulating or forcing the budgeting of taxes throughout the period of income realization, such devices as collection at source and a system of voluntary or compulsory purchase of tax-anticipation stamps can remove many of the barriers of high cost, evasion, and public resistance.

In the lower brackets, collection under normal methods of self-assessment and payment of taxes on the previous year's income is difficult enough. Ability to pay evaporates quickly, and deep resentment may easily be engendered by the necessity of lump-sum payments long after the close of the taxable year.⁵ In a wartime economy the problem is aggravated, for the pressure of rising prices leads to progressive illiquidity. As prices rise, the stimulus to full expenditure of unencumbered income also rises. The tax-gatherer will all too often be confronted with a bare cupboard.

To overcome the lack of tax liquidity, a multiple-installment plan of payments seems the logical answer. Such payments might be made by the individual income recipients on the basis of the prior year's incomes. But multiple direct contacts between government and, for example, mil-

⁵ Income Tax Commissioner C. B. Peterson of British Columbia, in a letter to the author (April 8, 1941) wrote as follows concerning the problem of collection of taxes on small incomes: "It is much easier to make refunds than to try to collect small amounts at the end of the year. Prior to the adoption of this 'collection-at-source' method we wrote off hundreds, yes thousands, of small amounts every year because it would cost more to enforce collection than the amount of tax involved."

lions of employees, would magnify both costs and inconvenience. The evident solution is to collect from the employer, that is, at source. And, since current deduction at source of taxes on the *preceding* year's income would involve additional negotiations between taxpayer, employer, and government, it is generally agreed that the tax withheld should be a tax on *current* income.⁶

The Problem of Transition

This conclusion plunges us directly into the problem of "pyramided" taxes. Imposition of new income taxes to be deducted currently at source (or collected promptly in some other manner) forces this year's income to support both this year's and last year's taxes. If the amount designated for at-source collection is a purely *additional* tax, leaving existing taxes undisturbed (except in so far as taxes withheld at source reduce the base for computation of taxes under existing rates), the problem is a recurrent one. Each year, taxes will be paid on both the current and the preceding year's incomes. If, however, the tax collected *on* and *from* current income is substituted for part or all of the existing tax, the problem is a transitional one.

For the recurrent problem, the solution would be to limit strictly the rate subject to prompt collection. Since this would hobble the income tax as an anti-inflation measure, it is desirable to shift at least part of the existing taxes from a delayed-collection to a current-collection system. During the year within which the move is made, a doubling-up of taxes occurs. It occurs even if there is no

⁶ The British tax collected at source on wages and salaries is in part, however, a tax on income of the preceding year which the employee instructs his employer to deduct for him. This system has the advantage of certainty of tax liability in advance of deduction at source, but fails to eliminate lags in tax collection. Albert G. Hart and Edward D. Allen, *Paying for Defense*, p. 169.

increase in rates. The taxpayer resistance which this might generate could jeopardize the entire program of increased reliance on income taxes. Some concession to ease the impact during the transitional year will very likely be necessary. Wisconsin, in a comparable move—from collection twice-removed to collection but once-removed from the year of income receipt—felt compelled, in effect, to give up one year's taxes.⁷ Current revenue necessities and price increases hardly permit the federal government to adopt a similar expedient. If the forced-loan feature is introduced at the time of the transition, the sting of added burdens might be partially removed. It will probably be necessary, however, especially if a substantial rate increase accompanies the shift from delayed to current collection, to abate or remit at least the normal tax on the previous year's net income. This seems a reasonable price to pay for the prevention of hardship and the retention of taxpayer good will.

Other Considerations

What other principles should a collection system incorporate to ensure its maximum contribution to the administrative success of heightened and broadened heavier income taxes? Attention has already been directed to (1) the desirability of an accelerated collection system which embodies automatic budgeting of taxes, and (2) the necessity

⁷ When the Wisconsin income tax was adopted in 1911, a two-year spread between receipt of income and collection of tax was incorporated into the law. Income earned in 1911 was reported in 1912 and taxed in 1913. Repeated efforts to reduce the spread to one year, the while protecting the interests of the state by accelerated tax collections to "take up the slack," were defeated. When the lag was finally reduced from two years to one year in the early thirties, the state gave up the taxes on income of one of the two years involved in the transition. The only concession to the state was that the year dropped in each individual case was the one involving the smaller tax.

of transitional adjustments. But other stimuli to economical administration and taxpayer acceptance should be built into the collection plan.

One of the most important is the prevention of discrimination among various classes of income recipients. Taxpayer morale cannot but suffer if one class, say, wage-earners, is singled out for an undue share of the burden. Yet, if prompt collection techniques are designed exclusively in terms of collection at source, only salaries, wages, interest, and dividends will be successfully tapped. True, such items constitute three-quarters of total income payments.⁸ But the remaining quarter confronts advocates of a prompt collection scheme with a problem of first magnitude. Unless that scheme is adapted to draw upon current incomes not subject to withholding at source, especially on incomes of the self-employed, with whom the laborer most readily compares himself, the charge of class legislation will be hard to avoid.⁹

But broadening of the prompt collection system is to be sought, not only to make the tax more palatable, but

⁸ Department of Commerce figures show that salaries and wages comprised 63 per cent, and interest and dividends, 13 per cent, of total income payments in the period 1935-39. Hart and Allen, *op. cit.*, p. 165.

⁹ The problem of devising techniques capable of successfully taxing incomes of the self-employed, and thereby avoiding discrimination against the wage-earner, involves much more than collection methods. As income taxes are extended into the lower brackets, the problem of ascertaining small business, professional, and farm incomes becomes acute. Since adequate records are a rarity, some form of presumptive or indicia income determination, relying chiefly on easily-ascertained external indices, may be a prerequisite to success. For small businesses, presumption might use gross income or even cost of goods sold as a starting point. Indices of productivity and prices might be used in estimating farm incomes. Development of new income determination devices faces many obstacles: lack of standardized measures, gaps in required knowledge, lack of agreement on approaches, and the necessity of a radically different psychology of administration and compliance. All of these indicate that presumptive techniques, however desirable in the long run, are probably not capable of sufficiently speedy development to meet the needs of wartime fiscal policy.

also to increase its net yield. Small incomes are not limited to areas subject to deduction of taxes at source. If it is agreed that the maximum tax tolerance of low-level income recipients is limited to small doses, a system of small doses must be applied to all in that category. Otherwise, it will be difficult to hold evasion and cost to reasonable levels.

Economy in administering a small-incomes tax has thus far been discussed mainly in terms of decreased taxpayer resistance and prevention of tax illiquidity; and those factors are undoubtedly the most important ones which make deduction at source and allied prompt-collection methods an economical measure of administration. But granting that such measures are necessary to administer wartime income taxes successfully, one can still recognize more and less expensive variants. The degree of internal economy achieved by collection-at-source hinges primarily on the methods adopted for adjustment of the tax to the personal status of the employee. Whether or not personal exemptions are taken into account in computing taxes to be deducted at source will largely determine the volume of necessary refunds. That volume, in turn, is the determinant of much of the cost of the system to the government. It is to the government's advantage to minimize refunds. But considerations of taxpayer equity and relative costs of operation to employers and government may point to a liberal refund policy. The collection system should strike a proper balance between (1) the interest of taxpayers in the cash (in excess of ultimate tax liability) which collection-at-source immobilizes; (2) the interest of employers in low compliance costs; and (3) the interest of the government in low administrative costs.

Collection Methods and the Fight Against Inflation

Prompt collection methods can make an independent contribution to the anti-inflationary force of an income tax. For the aim of that tax, under present conditions, is to siphon off increased purchasing power before it expresses itself in the inflationary pressure on a limited supply of civilian goods.

Collection *now* on the basis of *current* income makes the income tax a much sharper weapon of fiscal policy. In a period of rapidly rising prices and increased business activity incomes rise rapidly. To collect currently only the tax which is spawned by the lower incomes and prices of the preceding year is to close the coop after some of the prize chickens have flown. But more than that, our traditional delayed-collection system, in effect, loans the taxpayer his taxes on current income until the succeeding year. If the taxpayer uses that loan to increase current consumption, and particularly if he is forced to resort to borrowing to discharge his tax liability when it eventually falls due, the collection system is a stimulant rather than a sedative to inflation. The remedy is to end such loans by prompt collection techniques.¹⁰

It is not usually recognized that the use of such techniques introduces an element of flexibility which can be a valuable adjunct to postwar fiscal policy. For just as the wartime transition to, and use of, a current-collection sys-

¹⁰ The logic of this argument also calls for the omission of an interest premium on amounts promptly collected. For the government, by collecting promptly, is merely exercising a privilege that has lain long dormant. What is referred to as "advance payment" of taxes is in reality only current payment. The logic of this position does not bear fruit, however, unless all taxpaying segments are treated substantially alike. For until everyone pays taxes at the time of income accrual, it may be necessary to provide an interest premium to match the subsidy of tax deferment granted to those not covered by the prompt collection system.

tem has a deflationary effect, the reversion to a delayed-collection scheme after the war could be used in a reflationary manner to free funds for current use and consumption.¹¹

To perform their full stint in preventing inflation, prompt collection methods must be broad in their application. Unless the taxes currently withdrawn apply to the self-employed as well as to the rank and file of laborers, the latter cannot be expected to play the game. If their purchasing power is singled out for extermination or impounding, they will have an added stimulus to use their organized pressure to "administer prices upward," to borrow a phrase from Professor Hart.

The potential contribution of a skillfully drafted plan for prompt collection of income taxes in wartime is indeed great. It is not contended here that techniques alone can transform any given tax, however objectionable, into a useful instrument of fiscal policy. But given an income tax, with great inherent potentialities, they not only facilitate its adaptation to the demands of defense, but also lend a potent hand in the battle against inflation.

AMERICAN EXPERIENCE IN PROMPT COLLECTION ¹²

Prompt collection schemes have been adopted by several North American jurisdictions to draw forth at least part of their income tax revenue during the period of income accrual. Thus, Philadelphia collects its gross income

¹¹ It is very likely, however, that, for reasons of administrative efficiency, prompt collection techniques, once adopted, will be retained.

¹² For a more detailed discussion of collection-at-source experiences in North America, see Walter W. Heller, "Taxation of Small Incomes and Collection-at-Source (With Special Emphasis on American Administrative Experience)," and A. G. Hart, "Details of Proposals for Prompt Collection of Income Taxes," both in U. S. Senate, Committee on Finance, *Hearings on the Revenue Act of 1941*, pp. 400 and 415, respectively.

tax at source; New York State relies on deduction at source to extract a tax from nonresident employees; British Columbia has withheld taxes on wages since 1931, and Canada has recently drawn wages, interest, and dividends into the orbit of source-collection under its national defense tax. Moreover, the federal government has made a hesitating excursion into the realm of prompt collection through its recent provision of tax savings notes for advance payment of income taxes. Since these experiences offer valuable evidence on the efficacy and mechanics of accelerated collection schemes, they will be briefly reviewed at this point.

Collection at the Source

Philadelphia. Of the source-collection systems cited, Philadelphia's probably contributes least to the experiential background of the problem at hand. For the Philadelphia tax is a gross income tax and consequently circumvents the crucial problem of adjusting for personal circumstances.¹³ In this respect it is similar to the social security payroll tax system, which is valuable here chiefly as a potential source of information on lower bracket wages and as a psychological prelude to at-source taxes on net income.

The Philadelphia scheme requires no returns from individual employees if ". . . the entire earnings for the year are paid by one and the same employer and the . . . tax has . . . been withheld . . ." ¹⁴ This provision was designed to exempt the great majority of wage earners from filing, and the deputy receiver of taxes estimated that only one-fourth would be required to file in 1940. Although

¹³ The tax is levied at a rate of 1½ per cent on gross wage income and net business and professional profit earned within the city whether by residents or nonresidents.

¹⁴ *Philadelphia Income Tax Regulations*, Article III.

those not fully covered by collection at source do not need to pay taxes until March 15 of the year following the receipt of income, an optional plan for current payment of taxes has been devised. Upon receipt of an application for permission to pay the city income tax monthly in advance, the tax agency sends out an abbreviated tax return to the applicant each month. He returns this with his remittance. This would be a cumbersome system if applied on a national scale, but might be deemed desirable in certain income areas if other methods could not be found.

Although the Philadelphia experience offers little else of value in the instant connection, it is of interest to note that source-collection eased a financial crisis by immediate production of revenue.¹⁵

New York. Although a number of states withhold taxes at source from payments to nonresidents, only the New York system involves sufficient volume to be of real significance. That state, in 1939, collected a net income tax for 73,831 employees from 9,058 employers, and paid out over 10,000 refunds. Approximately \$3,350,000 was collected at source.¹⁶

The methods of adjusting for personal status, for deductions, and for additional items of taxable income bear close scrutiny by those who would use the collection-at-source device in federal income tax administration. Employees submit a card declaring their exemption status to their employers. The latter fill out the reverse side of the card and compute taxes at progressive rates after deducting appropriate exemptions. The cards, together with the with-

¹⁵ A budgeted revenue of \$17,000,000 was collected at a cost of about \$200,000, or 1.2 per cent. Hart, "Details of Prompt Collection Proposals," *Hearings on the Revenue Act of 1941*, p. 417.

¹⁶ Data supplied in letters to author dated April 8 and April 16, 1941, from Roy H. Palmer, Director, Income Tax Bureau, New York State Department of Taxation and Finance.

held taxes and summaries, are submitted to the state tax authorities before February 15 of the year following receipt of the income. Employees then file regular income tax returns, listing thereon their allowable deductions and any additional income taxable in New York. If the computed tax is greater than the amount withheld at source, the taxpayer remits the additional sum, but if the tax is less, his return is an automatic claim for refund.

Valuable as the New York experience is, it lacks one element essential to a full-fledged current collection system, namely, steady liquidation of the tax liability as the income is being earned. For, although it is assumed that the employer will anticipate the tax payment by withholding amounts from wages throughout the year, the common practice is to deduct the entire amount from the December paycheck of the employee. Despite this infirmity, the source-collection system is held in high regard by New York administrators, who feel that the system is simple, that it improves compliance, and that it does not unduly burden employers.

British Columbia. An even more instructive experience is that of British Columbia. That province has been successfully taxing wage income at source since 1931. It adds to the New York scheme the important element of spacing tax deductions throughout the year, but subtracts the element of employer adjustment for personal status. The employer merely withholds and remits monthly one per cent of all individual wage payments amounting to \$60 or more monthly, \$30 or more semimonthly, or \$14 or more weekly; these limits are pitched roughly to the British Columbia exemption of \$600 for single persons. Since exemptions for married persons are \$1,200, and credits for dependents an additional \$200, a great volume of refunds

is generated.¹⁷ Thus, during 1940, 141,516 refunds, which consumed \$1,000,576 out of \$2,066,356 collected at source, were paid upon filing of automatic refund claims in the form of personal returns.¹⁸

Although it might be thought that the system would bog down under this great load of refunds, the contrary is apparently the case. In response to an inquiry about the refund phase of the system, C. B. Peterson, British Columbia Commissioner of Income Tax, wrote:

Although it (the British Columbia source-collection system) involves the making of a large number of refunds, it seems the only logical method of collecting taxes from low-income groups. . . . Once the system has been brought to a well-established routine, it is not expensive to operate.^{19, 20}

He further asserted that unclaimed refunds constitute "a substantial sum of what one might call 'found money.'" This is said to be more than sufficient to pay the cost of administering the stoppage-at-source system.

The words of Commissioner Peterson on the matter of employee reaction to this system may also be quoted with profit:

It might be interesting to mention that this deduction at source is far from being unpopular with the employee, in fact, once they become accustomed to it, the deduction is not missed and the refund at the end of the year is very popular. We find them very appreciative of getting a few dollars back, and they seem to forget about the larger amount that has been retained as assessed tax. Even those who have

¹⁷ These exemptions were being revised upward in 1941 to coordinate the provincial tax with the Dominion tax.

¹⁸ Net taxes at source constituted just half of the total individual income tax collections of \$2,115,537. These figures were furnished by Commissioner C. B. Peterson in a letter to the writer dated April 8, 1941.

¹⁹ An average of only 10 employees is assigned to refund work.

²⁰ This and immediately following statements are excerpts from the Commissioner's letter of April 8, 1941. See also footnote 5.

an additional amount to pay appreciate the fact that a portion of it, at least, has been taken care of.

The British Columbia scheme has not only been popular with administrators and employees, but has also gathered in taxes promptly at low cost. Although the system was modified in 1941 to synchronize it with the Dominion plan of source collection inaugurated in 1940, its ten-year life history represents a real achievement in adaptation of this device to American soil.

Canada. Utilizing our yardstick of additions and subtractions, we find that the Canadian defense tax collected at source²¹ restores essentially the New York system of requiring employees to claim, and employers to apply, appropriate exemptions; retains the British Columbia feature of deductions throughout the year; and adds interest and dividends to the register of incomes tapped through at-source techniques. Moreover, to increase revenue and to minimize the number of refunds, the tax is levied on *total* net income of all persons whose incomes exceed the allowable exemptions of \$660 for single and \$1,200 for married persons. That is, exemptions are used only to determine who shall be liable to tax, but once liable, the taxpayer is taxed on total net income without benefit of exemptions.

Through this unusual device, refunds have been held to strikingly low figures. Though deductions at source were made for 1,200,000 employees by 76,104 employers in the first year of operation (from July 1, 1940, to June 30, 1941), only 7,817 refunds totalling \$46,710 had been granted by October 31, 1941.²² This small number prob-

²¹ Though the bulk of this tax—which is in addition to the regular Canadian income tax—is collected at source, *total* net income from whatever source derived is subject to its rates of 5 or 7 per cent.

²² Data supplied by Canadian Income Tax Commissioner in a letter to the writer, dated November 26, 1941.

ably reflects, in part, the newness of the tax, but the tax is so set up that great expansion in refund magnitudes is very unlikely.

Whether the Canadian tax has strayed too far from the path of equity in the interest of administrative simplicity cannot be categorically decided. The Canadian system is being carefully studied by federal officials for possible adaptation to use in the United States. It is unquestionably the most useful of all American experiences. Its apparent success administratively, as well as in expediting the withdrawal of purchasing power, is an impressive testimonial to the general efficiency of source-collection schemes. An appraisal of the Canadian system should, however, balance the price paid in less solicitous treatment of the taxpayer against the administrative advances that have been scored.

Out of the elements comprising the source-collection systems just reviewed, a plan suited to the federal income tax could probably be built. At most, the United States could adopt one of these systems to meet its own collection problems; at least, it should use these American experiences as a foundation on which to build.

Pre-Payment of Income Taxes Through Purchase of Tax Stamps

A federal venture of recent origin also contributes to the list of American attempts to expedite income tax payment. Since August 1, 1941, tax savings notes in denominations ranging from \$25 to \$100,000 have been available to individuals and corporations wishing to provide for taxes in advance of the due date. The notes are issued in two series: Notes of the first series (Series TA) yield 1.92 per cent interest and may be bought (at par plus accrued

interest) in a maximum amount of \$2,400. Notes of the second series (Series TB) yield only .48 per cent, but may be bought in unlimited amounts. Interest is realized only if the notes are used to discharge tax liabilities.

Sales of tax savings notes as of November 22, 1941, totalled \$1,894,452,950.²³ Although a breakdown between corporate and personal purchases is no longer available, an earlier figure (for late September) showed sales of one billion dollars to corporations, compared with a modest \$66,000,000 purchased by individuals.²⁴ On that basis, perhaps \$125,000,000 of the present figure represents individual purchases. This is less than five per cent of anticipated income taxes on 1941 individual incomes.

Neither the method of purchase nor the available scale of face values is conducive to broad use of this device for the budgeting of personal taxes. Local banks, which are the primary distribution centers, do not have a supply of notes on hand. Rather, they are restricted to taking of applications and cash for transmission to a Federal Reserve Bank, which then issues the notes. The local banks are given no incentive to stimulate the sale of the notes, in fact, they are not even reimbursed for their expenses in handling the applications. The taxpayer seeking to buy notes is, therefore, often confronted with either reluctance or ignorance concerning this tax-anticipation device.²⁵

Moreover, a minimum denomination of \$25 for these tax "stamps" falls far short of meeting the needs of the low-income groups, where advance budgeting of taxes is most urgent. Stamps should be easily available for direct pur-

²³ Figure furnished by United States Treasury Department.

²⁴ *United States News*. September 26, 1941, p. 8.

²⁵ A canvass of banks in Madison, Wisconsin, revealed only one which was both willing to serve and thoroughly informed in matters pertaining to tax notes.

chase at familiar stations, such as post offices; should range as low as \$1 in face value; and should carry an attractive rate of interest. The proportion of total personal tax liabilities discharged in advance will remain small under voluntary methods unless the stamps are made both attractive and readily available.

A SUGGESTED PLAN FOR PROMPT COLLECTION

The major ends which have emerged as legitimate objectives of a prompt collection system in a wartime period of increased reliance on income taxes are: (1) to maximize anti-inflation potentialities of income taxes; (2) to minimize taxpayer resistance, especially that which grows out of the charge of class legislation; and (3) to maintain administrative costs and tax evasion at reasonable levels. American experiments to date, though of great experiential value in constructing accelerated-collection schemes for federal income taxes, have fallen short of these goals.

The writer would like to submit here a plan under which prompt collection could, so to speak, fulfill its destiny. Details of the proposal, together with a citation of its advantages and disadvantages, are appended to this paper in outline form. Only a few of its salient features need be reviewed here.

The plan, to attain maximum coverage, combines the techniques of source-collection and compulsory prepayment of taxes through purchase of tax stamps. With respect to recipients of wages, interest, and dividends, it would telescope the two devices. It assumes, but does not depend on, adoption of a Keynesian forced-loan scheme.

On wage income, the proposal is essentially this: Withhold currently, at source, a flat-rate tax on incomes in excess of prorated personal exemptions. As evidence of

withheld taxes, give the worker tax stamps which he may convert at the year's end into government bonds (Professor Hart would call them "certificates"), taxes, or cash. The exact *quid pro quo* received for the stamps depends on the size of total income for the year. Both refunds and hardships are held to a minimum by employers' adjustments at the source for employees' personal status, and by full convertibility of stamps into forced-loan bonds if total liability does not exceed a stated amount, say, \$25, of tax. Stoppage at source evidenced by convertible tax stamps also applies to interest and dividend payments.

Still uncovered are the self-employed, to whom source-collection is inapplicable. The suggested solution here is to require such taxpayers, under threat of heavy penalties, to purchase in advance (i.e., during the period of income realization) enough tax stamps to discharge perhaps three-quarters of their income tax liabilities. This requirement might be applied with reference to either (1) all types of income not subject to withholding at source, or (2) only business, professional, and farm incomes.

The foregoing provisions constitute the broad outlines of the proposal. Many of the details are supplied in the appended statement. Others would have to be filled in during the course of legislative and administrative action.

In so far as collection methods, either under this or some alternative plan, can help make a broadened income tax workable, palatable, and prompt in its incidence, they will contribute tellingly to the effectiveness of wartime fiscal policy.

APPENDIX

A COMBINED COLLECTION-AT-SOURCE SYSTEM AND TAX
STAMP PLAN FOR PROMPT COLLECTION OF HEAVY
DEFENSE LEVIES ON INCOME

I. An at-source collection system and tax stamp plan applied to wages (assuming exemptions of \$500 for single persons, \$1,000 for married persons, and \$250 for dependents, to be deducted during a 50-week period).

A. Deduction of "taxes" at source

1. A designated percentage (preferably a flat rate not above—nor below—the minimum rate of tax plus forced loan that it is desired to impose on the very small incomes) of all wage payments over \$10 per week to single employees, and over \$20 to married employees, is deducted by the employer. (The exempt minimum would be increased \$5 for each dependent. It might also be desirable to add an arbitrary allowance for deductions to the exempt minimum. Here, the compliance burden on the employer must be balanced against both the possible hardship to the employee and the refund problem confronting the government.)
 - a. Deductions are made at the time of regular issuance of paychecks (or bonuses), but in no case less often than once a month.
 - b. Deductions are rounded off to the nearest ten cents.
 - c. Records of individual employees' at-source deductions throughout the full period covered (ordinarily a year) should not be necessary.
2. Employer submits tax stamps to employee in pay envelope, as evidence of the taxes withheld at source (from the paycheck contained in the pay envelope).
 - a. Stamps are available at post office (and perhaps banks) in denominations of \$.10, \$.30, \$.50, \$1.00, \$2.00, \$5.00, \$10.00, and \$25.00.

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- b. Employer purchases stamps in advance, getting receipts therefor. Receipts are later submitted to revenue authorities to evidence purchase of stamps. (Comparison with total payrolls affords a very rough check on the adequacy of deductions made. If one cannot assume that the convertibility of stamps [see I, B] is a sufficient spur to employees to reveal attempts at evasion, some further check on employers may need to be devised.)
- c. The stamps do not bear interest.
- d. On their face, the stamps say, "Nontransferable. Do not destroy. Convertible after January 1, 194- into bonds, taxes, or cash, according to the size of your total income for 194-."
- e. Stamps are nonnegotiable and nontransferable. Heavy penalties apply for attempts to transfer stamps. Incentives to transfer are minimized because holdings of tax stamps are an indication of receipt of taxable income.

B. Conversion of tax stamps

- 1. If income is not above a stated amount, say, \$500 more than exemptions, stamps are to be converted wholly into forced-loan bonds. (The limit below which stamps are wholly convertible into bonds might, to prevent inequity, be stated in terms of a fixed amount of tax.)
 - a. Under one alternative plan, no return would be filed. To prevent conversion of stamps wholly into bonds, when a tax is actually due, some supplementary check would be necessary. This might be made through the use of social security records, where total wage income is shown. All those with wage incomes below the set limit would be ignored. All those with wages above the limit who had not filed returns would be subject to delinquency proceedings and cash payment of taxes.
 - b. Under the other alternative, a sworn income declaration (as brief as possible) must accompany the stamps at the time of conversion. Conversion might be made either at post offices or directly by revenue authorities.

2. For incomes above the limit fixed in I, B, 1, a regular return must be made out by the individual. (The lowest over-all rate on the first \$1,000 of income after exemptions should perhaps be equal to the percentage deducted at source, although it may be desirable to make part of the total a tax payment, and part, a forced-loan, as income goes above the limit in 1.) Tax stamps are only partially converted into forced-loan bonds. The rest are used to pay taxes, and, as incomes rise, cash may also be needed to discharge total tax obligations.
3. If total deductions at source are greater than the individual's combined forced-loan and tax liability, owing to part-year employment or existence of dependents, the individual could convert his tax stamps into either:
 - a. Cash, by a request for refund, or
 - b. Voluntary savings bonds, bearing an "inducement rate" of interest to attract such finds. (H. M. Groves has suggested that interest rates adjusted to quotas based on total liabilities on account of income taxes—and forced loans—be provided as a stimulant to such voluntary saving.)

II. An at-source collection system and tax stamp plan applied to interest and dividends.

A. Deduct a flat percentage at source on such payments, and transmit tax stamps for that amount to payee along with his interest or dividend check. Since many people depend wholly on such income, some plan for exemption-allowance would very likely be necessary.

B. Permit conversion of stamps in same manner as under I, B, above.

C. Other property incomes taxed either as at present—at end of year—or as under III, A, 1, below.

III. A prompt-collection plan for incomes not subject to deduction of taxes at source. (Especially applicable to business, professional, and farm incomes, i.e., incomes of the self-employed.)

FINANCING THE WAR

A. General requirement: Either

1. An over-all plan under which all forced-loan obligations and a specified percentage of tax obligations must be paid with tax stamps obtained (during the preceding year) either by purchase, or as evidence of deductions at source, or
2. For the self-employed only, a specified proportion, perhaps three-quarters, of taxes and forced-loan obligations, to be paid in tax stamps bought during the preceding year.

B. Purchase of stamps

1. Amounts to be bought determined either on basis of
 - a. Previous year's income, or
 - b. (If adequate techniques are developed) current net income as determined presumptively with the aid of objective criteria such as gross income, yield and price data (for farmers), etc., or
 - c. Income recipients' best estimate of expected current annual income.
2. Stamps to be differentiated in format from those which represent withholding of taxes at source.
3. Stamps to be purchasable at post offices—time of purchase to be discretionary (i.e., within the year of income accrual). Penalties of, say, 10 per cent of total tax liabilities, are applied for failure to pay three-quarters of tax in the form of stamps purchased in advance. Publicity is the chief reliance to stimulate spacing of purchases throughout the year.
4. If enforceable, a prescription that purchases are to be spaced throughout halves or quarters of year should be applied. This would require dating of the stamps and an added and burdensome administrative operation. (Forced spacing of purchases of stamps—at least within broad periods—seems desirable to force advance budgeting of taxes and to ensure prompt payment as a source of revenue and as a weapon of fiscal policy for the government.)

ADVANTAGES AND DISADVANTAGES OF FOREGOING PLAN

Advantages

1. It has the usually cited advantages of the collection-at-source system, such as convenience and timeliness of payment and enforced budgeting of taxes.
2. It preserves tax-consciousness and gives the wage-earner a sense of participation in the fiscal defense plan. Moreover, by drawing on *all* forms of income through the tax-stamp plan it avoids the feeling of wage-earners that they are being singled out to make disproportionate sacrifices.
3. It permits a maximum of flexibility and facilitates complete integration of the joint tax and forced-loan (and even, if desired, the "induced" voluntary loan) program. Forced loans and taxes collected at source are completely integrated with the regular income tax in one over-all progressive scale. No element of progressivity is sacrificed and maximum flexibility is maintained, since total rather than fragmentary income of each individual is used as a base. Thereby adjustments, to take care of doubling-up of taxes in the period of transition from delayed collection to prompt collection, are also facilitated.
4. This plan makes the prompt-collection system all-inclusive. The "submerged" areas not subject to collection at source, i.e., business, professional, and farm incomes in particular, are brought into the system through required purchases of tax-anticipation stamps. In fact, part III of the plan can stand alone as an adjunct to any collection-at-source system.
5. Much of the operation of the system is semi-automatic, since there is a great stimulus to income declaration in the convertibility of tax stamps either into bonds, taxes, or, in some instances, cash. Much of the bookkeeping load is shifted, merely through the accumulation of tax stamps, from the government and the income payer to the taxpayer.
6. Cash refunds are reduced to a minimum both by the adjustments at source and by the convertibility of stamps into bonds.

Disadvantages

1. Adjustments for personal circumstances and additional income and deductions offer the usual complications of a collection-at-source system, though the tax stamps and existence of a forced-loan plan facilitate the adjustment with a minimum number of refunds.
2. There is a considerable burden of compliance on the payer, but he does not have to provide for rate differentiation, nor keep account of amounts deducted at source for each individual, since the stamps are an automatic index of this. Moreover, allowance for marital status can be reduced, as illustrated above, to a minimum of complexity.
3. Like all new plans for prompt collection, this plan calls for considerable reorientation and for new administrative devices. The administrative handling of myriads of tax stamps is difficult, and the loss of stamps by individuals will create some embarrassment.

Conclusion

It is submitted that the foregoing plan for prompt tax collection is an effective way to (1) promote taxpayer acceptance of new and heavier income taxes; (2) facilitate use of the income tax as an instrument of wartime fiscal policy; (3) avoid discrimination in burdens among taxpaying groups; (4) minimize both voluntary and involuntary default on taxes among recipients of small incomes; and (5) maintain a reasonable cost of administration in the face of a broadening of the income tax base.

CHAPTER XII

STATE TAXATION OF DEFENSE ACTIVITIES FROM THE FEDERAL VIEWPOINT

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It is especially appropriate to discuss state taxation of defense activities in Philadelphia. It was in this city that the propriety of such taxation was first debated more than a century and a half ago.¹

The members of the Continental Congress in session in this city in 1779 were confronted with heated protests of the Quartermaster General and two Assistant Quartermasters General of the Continental Army, who complained that the state of New Jersey sought to impose upon them a specific tax of one thousand to ten thousand pounds, the exact amount to be fixed by the state's assessors. Special committees of the Continental Congress filed three reports on the New Jersey law which approved state taxation of the offices created by the general government, if it was non-discriminatory, but condemned the New Jersey law because it singled out certain Army officers for special taxation. For this reason the committees recommended that New Jersey be requested to repeal the tax.²

The Congress of 1779, however, failed to take any action on these recommendations. Finally, Charles Petit, one of

¹ 14 *Journal of the Continental Congress*, 744, 787, 808, 931; 15 *id.* 1198; see 10 *id.* 210.

² Report of June 28, 1779, 14 *Jour. Cont. Cong.*, 779-80; Report of July 8, 1779, 14 *id.* 807-8; Report of August 6, 1779, 14 *id.* 930-33.

the Assistant Quartermasters General, wrote a letter to the Congress in which he stated that New Jersey tax officials had called upon him to pay the tax. A motion to refer this letter to committee was defeated by a vote of seven states to four,³ and it was suggested, today we might say naively, that the officer place himself on the mercy of New Jersey.

From this incident during the War of Independence to the recent Act of the New Jersey Legislature, which carved from an existing township a new municipality having identical boundaries with a defense housing site,⁴ there have been many similar clashes of federal-state tax policy. My purpose is to sketch briefly some recent developments in this conflict.

NEW FEDERAL-LOCAL RELATIONSHIPS

Problems of production presented by the war and problems of procurement arising from the lend-lease and defense programs have multiplied the activities of federal departments and agencies throughout the country. These activities have been of many kinds, such as the construction of army camps, munition plants, shipyards, and houses for defense workers, as well as the purchase of armament, raw materials, clothing, and food. The taxability of these defense activities raises questions which search some of our fundamental assumptions regarding the proper relationship between the national government, on the one hand, and state and local governments on the other.

It has been said that, prior to 1932, with one or two exceptions, no mention of the word "city" appeared in the

³ 15 *Jour. Cont. Cong.*, 1198.

⁴ *Laws of New Jersey*, 1941, Chap. 360.

statutes of the United States.⁵ Although it may now seem curious, this omission is easily understood. Before the enactment by Congress of the Emergency Relief and Construction Act of 1932,⁶ the national government had neither admitted, nor assumed, any obligation to cities or other local communities. That Act, however, authorized the Reconstruction Finance Corporation⁷ "to make loans to, or contracts with States, municipalities, and political subdivisions of States," as well as other public agencies and corporations.

By thus accepting responsibility for financing local public works, and by a series of significant laws passed subsequent to 1932, Congress foreshadowed a completely changed attitude toward federal-local relationships.⁸ The national government carried out a program of multiple-purpose projects, such as those of the Tennessee Valley Authority,⁹ and the Bonneville and Grand Coulee Dams in the Northwest.¹⁰ Those regional undertakings tended to dominate the economic life of the areas they served, at the same time that they developed great natural resources.

As federal activities expanded in fields which had previously been thought to belong exclusively to the states, the doctrine of intergovernmental tax immunity also became increasingly important. Thoughtful government officials

⁵ Morton L. Wallerstein, "Federal-Municipal Relations—Whither Bound," *National Municipal Review*, XXV (1936), 453.

⁶ 47 Stat. 709 (1932).

⁷ Emergency Relief and Construction Act of 1932, §201(a)(1), 47 Stat. 711 (1932).

⁸ E. H. Foley, Jr., "Recent Developments in Federal-Municipal Relationships," *University of Pennsylvania Law Review*, LXXXVI (1938), 485.

⁹ 48 Stat. 58 (1933), as amended by 49 Stat. 1075 (1935), 53 Stat. 1083 (1939), U. S. 76th Congress, 3d Session, *Public Resolution* No. 88 (1940).

¹⁰ These projects were constructed as part of the comprehensive program of public works prepared by the Federal Emergency Administration of Public Works, under the direction of the President, pursuant to Title II of the National Industrial Recovery Act, 48 Stat. 200 (1933).

began to urge the necessity for a comprehensive re-examination of federal-state-local tax policy. Secretary of the Treasury Morgenthau referred to the problem in 1939 during his testimony before the House Ways and Means Committee, and recommended "that Congress create a small temporary commission to report to Congress as soon as feasible on the various aspects of intergovernmental fiscal policy and propose a plan for the solution of the problems involved."¹¹ But as Professor Groves has pointed out in his important work, *Financing Government*, "Probably no problem in public finance has occasioned more talk and less action than this one of intergovernmental tax relations. It is a field in which indecision appears to be the outcome of all effort. It is to be hoped that something, however modest, will soon be achieved."¹²

Perhaps the defense program will impel the Congress, as it has the Supreme Court, to reconsider the doctrine of reciprocal immunity which denies to one government, national or state, the power to tax the agencies of the other.

THE BURDEN THEORY REPUDIATED

Within the last month the Supreme Court of the United States has re-examined the scope of that doctrine. On November 10, 1941, the Court decided three cases of far-reaching significance. The three decisions were unanimous. Because I think that these decisions mark important milestones in the judicial history of intergovernmental immunity, I should like to discuss them in some detail.

In the case of *Alabama v. King & Boozer*,¹³ the Court upheld the constitutionality of state sales taxation of con-

¹¹ U. S. House of Representatives, Committee on Ways and Means, *Hearings on the Revenue Act of 1939*, pp. 3-4.

¹² Harold M. Groves, *Financing Government*, pp. 504-5.

¹³ 62 Sup. Ct. 43 (1941).

tractors who purchase goods for the use of the United States. The Alabama legislature had enacted a sales tax of two per cent on the gross retail sales price of tangible personal property. The state revenue department had assessed the sales tax against the partnership of King & Boozer, which had sold lumber to contractors to use in building an army camp for the United States. The contractors had agreed with the United States to build this camp in return for a fixed fee plus reimbursement for all their expenditures, including state taxes.

The Alabama Supreme Court decided that the tax infringed the constitutional immunity of the national government, because the tax was in effect "laid on a transaction by which the United States secures the things desired for governmental purposes."¹⁴ The United States Supreme Court, however, reversed this decision and held that the purchasers of the lumber were not relieved of liability to pay the sales tax, "either because the contractors in a loose and general sense were acting for the Government in purchasing the lumber or, as the Alabama Supreme Court seems to have thought, because the economic burden of the tax imposed upon the purchaser would be shifted to the Government by reason of its contract to reimburse the contractors."¹⁵

In the companion case of *Curry v. United States*,¹⁶ decided the same day, the Supreme Court held that defense contractors were not immune from the Alabama use tax even though they used the materials, in respect of which the use tax was imposed, to perform their contract with the national government. The Court said that "the Con-

¹⁴ *King & Boozer v. State*, 3 So. (2d) 572, 578-79 (1941).

¹⁵ 62 Sup. Ct. 47 (1941).

¹⁶ 62 Sup. Ct. 48 (1941).

stitution, without implementation by Congressional legislation, does not prohibit a tax upon Government contractors because its burden is passed on economically by the terms of the contract, or otherwise as a part of the construction cost of the Government.”¹⁷

Earlier Decisions Reconsidered

In earlier decisions, the Supreme Court had considered it controlling whether the economic burden of a tax imposed upon a private person by one government, national or state, would be borne by the other government. If the economic burden upon the other government was considered remote or speculative, the Court would uphold the tax as valid under the Constitution. But if the economic burden upon that government was considered direct or certain, the Court would invalidate the tax as an unconstitutional burden.¹⁸

The Alabama sales tax statute, however, required the sellers (King & Boozer) to collect the tax from the purchasers (the cost-plus contractors); and the purchasers' contract with the United States specifically provided that the government would reimburse them for all state taxes they might have to pay. The Alabama use tax was also levied on cost-plus contractors. Consequently, there was nothing conjectural, speculative, or uncertain about the fact that both taxes resulted in an economic burden on the United States.

To uphold these state taxes, the Court had to repudiate

¹⁷ 62 Sup. Ct. 49 (1941).

¹⁸ See, for example, the opinion in *Graves v. Texas Co.*, 298 U. S. 393, 395 (1936), where the Court estimates the additional cost of gasoline to the United States if the tax were sustained, and assumes that this represents the “burden” on the national government. Cf. *James v. Dravo Contracting Co.*, 302 U. S. 134 (1937).

the so-called "burden theory" of intergovernmental immunity, and it did that in sweeping terms. Speaking for the Court, Chief Justice Stone in the *King & Boozer* case declared:

So far as such a nondiscriminatory state tax upon the contractor enters into the cost of the materials to the Government, that is but a normal incident of the organization within the same territory of two independent taxing sovereignties. The asserted right of the one to be free of taxation by the other does not spell immunity from paying the added costs, attributable to the taxation of those who furnish supplies to the Government and who have been granted no tax immunity. So far as a different view has prevailed, see *Panhandle Oil Co. v. State ex rel. Knox*,¹⁹ *supra*; *Graves v. Texas Co.*,²⁰ *supra*, we think it no longer tenable.²¹

In a third case, *Federal Land Bank v. Bismarck Lumber Co.*,²² also decided on November 10, the Supreme Court held that Congress has power to exempt from state taxation any government agency, and that a general exemption from "State, municipal, and local taxation" includes within its ban a state sales tax which makes the purchaser liable for the tax.²³

Summary of Recent Cases

Without going into further detail, I think that the following propositions are now well established:

1. Congress may consent to state taxation of federal agencies created by it,²⁴ or may exempt such agencies from state taxation.²⁵

¹⁹ 277 U. S. 218 (1928).

²⁰ 298 U. S. 393 (1936).

²¹ 62 Sup. Ct. 45 (1941).

²² 62 Sup. Ct. 1 (1941).

²³ Obviously distinguishing between a tax levied upon a public agency and a tax levied upon a private person, the Court added, significantly, "The bonds may be held by private persons, and, of course, the general exemption . . . would not extend to them." 62 Sup. Ct. 4 (1941).

²⁴ *Van Allen v. Assessors*, 3 Wall. (U.S.) 573 (1865); see *British-American Co. v. Board*, 299 U. S. 159, 161, 166 (1936).

²⁵ *Federal Land Bank v. Bismarck Lumber Co.*, *supra*, note 22; *Pittman v. Home Owners' Loan Corporation*, 308 U. S. 21 (1939); see also *Justices*

2. In the absence of Congressional consent, a state may not impose a tax upon the national government,²⁶ nor upon any agency of the national government devoted exclusively to carrying out functions of the United States.²⁷

3. In the absence of an exemption by Congress, a state having jurisdiction to tax may levy a sales tax,²⁸ use tax,²⁹ gross receipts tax,³⁰ social security tax,³¹ or occupational tax³² upon any federal contractor, regardless of whether his compensation under the contract is a lump sum³³ or is cost-plus;³⁴ and a state may also levy a non-discriminatory net income tax upon any such contractor,³⁵ as well as upon any federal licensee,³⁶ lessee,³⁷ or employee.³⁸

Of course, states and municipalities might voluntarily abstain from applying all these taxes to defense activities on the ground that they receive compensatory benefits from these activities which more than offset the burdens. I do not intend, however, to discuss the issue whether states should, or should not, exempt defense activities from taxation. The question which I would like to consider now is how far the national government can safely go in consent-

Brandeis and Stone concurring in *Miller v. Milwaukee*, 272 U. S. 713, 716 (1927).

²⁶ *Van Brocklin v. State of Tennessee*, 117 U. S. 151 (1886). Cf. *New Brunswick v. United States*, 276 U. S. 547 (1928).

²⁷ *Clallam County v. United States*, 263 U. S. 341 (1923).

²⁸ *Alabama v. King & Boozer*, *supra*, note 13.

²⁹ *Curry v. United States*, *supra*, note 16.

³⁰ *James v. Dravo Contracting Co.*, 302 U. S. 134 (1937).

³¹ *Buckstaff Co. v. McKinley*, 308 U. S. 358 (1939).

³² *Rainier National Park Co. v. Henneford*, 182 Wash. 159, 45 P. (2d) 617 (1935); cert. denied 296 U. S. 647 (1935).

³³ *James v. Dravo Contracting Co.*, *supra*, note 30.

³⁴ *Alabama v. King & Boozer*, *supra*, note 13; *Curry v. United States*, *supra*, note 16.

³⁵ *Atkinson v. State Tax Commission*, 303 U. S. 20 (1938).

³⁶ *Fox Film Corp. v. Doyal*, 286 U. S. 123 (1932), overruling *Long v. Rockwood*, 277 U. S. 142 (1928).

³⁷ *Helvering v. Mountain Producers Corp.*, 303 U. S. 376 (1938), overruling *Gillespie v. Oklahoma*, 257 U. S. 501 (1922), and *Burnet v. Coronado Oil Co.*, 285 U. S. 393 (1932).

³⁸ *Graves v. New York ex rel. O'Keefe*, 306 U. S. 466 (1939), overruling *New York ex rel. Rogers v. Graves*, 299 U. S. 401 (1937), and *Collector v. Day*, 11 Wall. (U. S.) 113 (1870).

ing to state taxation of defense activities, without impairing the freedom of action and choice which is the essence of its sovereignty. As the law stands now, defense activities are fully taxable by the states if the legal impact of the tax falls upon private persons, notwithstanding that the economic burden is shifted to the government; but such activities are exempt from state sales or use taxes, even though nondiscriminatory, if the legal impact of the tax falls upon the national government.

RECIPROCAL NONDISCRIMINATORY TAXATION

The question is one of great difficulty and delicacy. I might venture to suggest, however, that serious consideration be given to making all business transactions between either government, national or state, and a private person, subject to nondiscriminatory taxation by the other government. If this policy is to be reciprocal, it involves not only subjecting defense activities to state taxation, but also eliminating the extensive and virtually uniform exemption from federal excise taxes now granted to private persons who manufacture or sell commodities to states and municipalities.³⁹ After all, federal and state tax laws ought

³⁹ The Internal Revenue Code contains a general exemption of sales to states and municipalities from manufacturers' excise and import taxes. I.R.C. §§3442, 3443(a)(3)(A)(i). The provision was added by §621 of the Revenue Act of 1932, 47 Stat. 267 (1932), after the decision in *Indian Motorcycle Co. v. United States*, 283 U. S. 570 (1931). The retailers excise taxes added by §552 of the Revenue Act of 1941, 77th Congress, 1st Session, U. S. Public No. 250, contain a corresponding exemption of sales for the exclusive use of states and their political subdivisions. I.R.C. §2406. In addition, there is a long list of specific exemptions of articles sold to states and their subdivisions from the excise taxes on the manufacture and sale of vegetable oils (I.R.C. §2473), narcotics (I.R.C. §§2551[c][1], 3222[b]), pistols and revolvers (I.R.C. §2700[b][1]), machine guns and short-barrelled shotguns (I.R.C. §2721[a]), marihuana (I.R.C. §3232[b][1]), electric energy (I.R.C. §3411[c]), and telegraphic, cable, and telephone service (I.R.C. §3466, as amended by §548 of the Revenue Act of 1941). A corresponding exemption is granted from the documentary stamp tax (I.R.C. §1808[a]), and the vehicle use tax (Revenue Act of 1941, §557;

to apply to all citizens equally. Existing exemptions give a greater advantage to those who deal with government than to those who deal with private enterprise. So long as the taxation of business transactions is nondiscriminatory, it will neither prevent nor impede either the national or state governments in carrying on their operations, nor restrict their choice of the means by which they might seek to discharge their functions.

On the other hand, if Congress were to exempt defense contractors, for example, from nondiscriminatory state sales or use taxes, it could seriously interfere with the revenue-raising ability of taxing authorities which depend for substantial revenues on this form of taxation. For as our national economy becomes converted from a peacetime to a war economy, an ever-increasing proportion of goods and supplies will be sold for the ultimate use of the national government, and thereby the amount of business activity intended to be tapped by state transaction taxes will be reduced.

It is true that state taxation of sales to the national government would increase the cost of the defense program. But this increased cost appears overemphasized when we compare it with the amount of financial assistance which the national government is constantly giving to state and local governments.

If the national government were subject in its purchases, during the fiscal year 1942, to state sales taxes imposed upon the buyer, it has been estimated that the additional

I.R.C. §3540[j1]). However, the fact that a state or political subdivision charges admissions, or receives the proceeds of admissions, does not make such admissions exempt under the federal admissions tax (I.R.C. §1701 [a1][1], as amended by the Revenue Act of 1941, §541). See Regulations No. 43 (1941 edition), §101.16.

cost would amount to sixty-five million dollars.⁴⁰ But this amount does not seem shocking when one considers that during the last fiscal year about nine hundred million dollars, or a sum equal to nearly two-thirds of the federal individual income tax collections, was turned back to states, municipalities, and other public bodies, for agricultural education, public works, road construction and grade crossings elimination, public health and education of the blind, industrial rehabilitation, and vocational education.⁴¹

Moreover, the cost to the national government resulting from state taxation of defense purchases is counterbalanced by an equivalent gain to state and local government. The national government, however, has more effective fiscal powers than state or local governments; and for it to pay nondiscriminatory taxes on its transactions with private business firms would help finance local public undertakings on an automatic and an impartial basis, without establishing any complicated formula for federal aid.

State taxation of the property of the national government is different. Apart from considerations of principle, which may not be the same for taxes on property as for taxes on transactions with private persons, there is some practical advantage in recognizing an immunity from real and personal property taxes. The federal courts might find it necessary to examine numerous state laws and local ordinances relating to real estate valuation and the equalization of assessments for the purpose of determining delicate questions of discrimination.

Moreover, it is generally conceded that the collection of state and local personal property taxes is lax, unequal, and

⁴⁰ Brief for the United States in *Alabama v. King & Boozer*, *supra*, note 13, Appendix B, p. 25.

⁴¹ *Annual Report of the Secretary of the Treasury . . . 1940*, Table No. 66, pp. 818-21, and Table No. 67, pp. 822-25.

subject to vagaries of administration. In these circumstances, any state or local property taxation of the national government might well be regarded as discriminatory on its face.

Payments in Lieu of Property Taxes

In an endeavor to reconcile the viewpoint that the national government should not be subject to property taxes, and at the same time to find a method of contributing to the support of state and local governments, the experiment of making payments in lieu of taxes has been tried, but has not yet by any means been perfected.

During the fall of 1935, Secretary of the Interior Ickes, who was then also Federal Emergency Administrator of Public Works, asked the Comptroller General of the United States whether the Public Works Administration had power to make payments in lieu of taxes on two of its slum-clearance projects in Atlanta, Georgia.⁴² The Comptroller General ruled, however, that there was no statute authorizing the use of federal funds for this purpose.⁴³ The next year Congress passed two statutes authorizing payments in lieu of taxes for municipal services supplied to low-cost housing projects of the Public Works Administration⁴⁴ and also the Resettlement Administration.⁴⁵ Later, this policy was extended to apply to the United States Housing Authority,⁴⁶ the Tennessee Valley Authority,⁴⁷ and defense

⁴² Secretary Ickes' letter dated September 9, 1935, is quoted in the Comptroller General's Opinion, *infra*, note 43.

⁴³ 15 Dec. Compt. Genl. 295 (1935).

⁴⁴ Act of June 29, 1936, §2, 49 Stat. 2026 (1936).

⁴⁵ Act of June 29, 1936, §2, 49 Stat. 2036 (1936).

⁴⁶ United States Housing Act of 1937, §13(c), 50 Stat. 888 (1937).

⁴⁷ Tennessee Valley Authority Act of 1933, §13, 48 Stat. 58, 66 (1933), as amended by §39 of the Emergency Relief Appropriation Act, fiscal year 1941, 54 Stat. 611 (1941).

housing projects of the Federal Works Agency.⁴⁸ A recent bill for the creation of the Columbia Power Administration contains similar authority.⁴⁹

The problem of computing payments in lieu of taxes is very complex. A mere recital of a few of the questions involved will illustrate this. Should payments be made on all federal lands, or only on those receiving municipal services? Should the national government have a voice concerning how the money it pays will be used, or should the national public interest be otherwise represented? Should payments be determined by agreement between the federal agency and a state agency in accordance with a general formula provided in the statute, or should they be made on a basis of specified percentages or amounts fixed by the statute itself? Should payments be measured by the application of local tax rates against an estimated assessment, or should they be computed by capitalizing gross or net receipts?

In the case of defense housing projects, should the amount of the payment depend on the cost to the locality of the rendering of services to the undertaking? Should property leased to private persons by the government be treated differently from property it not only owns but operates? Should there be a fundamental distinction drawn between property owned by the national government and that owned by corporations created by it, or should a distinction be drawn between federal revenue-producing projects and nonrevenue-producing undertakings?

To whom should the money be paid—to the municipal

⁴⁸ Act of October 14, 1940, 54 Stat. 1125 (1940), as amended by Act of June 28, 1941, 55 Stat. 361 (1941), (popularly known as The Lanham Act).

⁴⁹ H. R. 6076, §17(d)(2), (Nov. 19, 1941). See also S. 1201 (March 24, 1941) which would require the Secretary of the Treasury to pay a sum equal to 2 per cent of the fair value of various types of real estate owned by the United States.

corporation, the county, the state, the school or fire district, or to all of them? And what kind of a formula should be used to allocate the payment in lieu of taxes among various subdivisions of the state?

The Federal Real Estate Board has been making a study of the matter and perhaps its forthcoming report will provide some of the answers to this perplexing problem.⁵⁰

CONCLUSION

The question of intergovernmental immunity has always been a cardinal problem of our constitutional system. At every turn of our national development we have been brought face to face with some new aspect of the problem. And now, with the defense program, the question has arisen once more. For us, as for previous generations, it is a crucial question because it lies at the heart of our governmental structure.

Reciprocal nondiscriminatory taxation of all private persons, even when they deal with governmental departments and agencies, is but the normal incident of our dual system of national and state governments, each operating within the same territory and upon the same persons. "The state and national governments must co-exist. Each must be supported by the taxation of those who are citizens of both."⁵¹ It is to be hoped that state taxation of defense activities, however ill-considered in a few instances, will not cause a departure from recognition of this fact.

⁵⁰ A report of a special committee on federal ownership of real estate and its bearing on state and local taxation was transmitted by President Roosevelt to Congress on January 16, 1939; U. S. 76th Congress, 1st Session, *House Document No. 111*. Federal legislation relating to payments in lieu of taxes is collected on pp. 8-11 of that report. The Federal Real Estate Board was created by *Executive Order 8034*, approved January 14, 1939, 4 Fed. Reg. 249 (1939).

⁵¹ *Helvering v. Gerhardt*, 304 U. S. 405, 422 (1938).

During these critical days the fate of democratic government throughout the world, no less than the fate of our own federal system, depends upon the skill and the wisdom with which we find the financial sinews for our war effort.

CHAPTER XIII

STATE TAXATION OF DEFENSE ACTIVITIES FROM THE STATE STANDPOINT

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IN DISCUSSING the state taxation of defense activities from the standpoint of state government, it has been assumed that the subject deals primarily, not with special forms of taxing defense activities as such, but with the application of established state tax laws to the defense program in what may, for the moment, be called the normal course of events. With the acceptance of this point of departure, the determination of what constitutes defense activities is the next order of business.

The expansion of the defense program, so rapidly accelerated by the fall of France in the spring of 1940, has emphasized the necessity for latitude in the designation of defense activities. As our national program of preparedness continues, an increasing number of goods and actions will be termed essential to defense. In fact, in these days in which mechanical equipment plays so vital a role in warfare, a state of total preparedness might result in including almost every economic good or activity under the defense caption. There is no attempt here, however, to reach a *reductio ad absurdum*, and for present purposes, it will suffice to treat the generally accepted phases of the armament program as constituting the defense activities of the nation. Their changing ratio in the national production pic-

ture will have but little effect upon the discussion which follows.

The right of the state to tax defense activities depends upon whether the tax would rest upon an instrumentality of the federal government. Who and what are these instrumentalities which may or may not be the proper objects of state taxation? This question has often been before state and federal courts. It has never been solved completely, nor is there indication that it will be soon. The courts have preferred to try each case on its merits and to refrain from laying down general rules. In the fog of uncertainty which has shrouded this phase of state taxation, it has now become clear that many of the old restraints have been relaxed in line with the disavowal of much of the theory which stressed intergovernmental tax immunity. The decisions have become narrower and narrower in defining the scope of such an instrumentality. Thus, there has been made available to the states a potential power to tax federal disbursements which did not exist twenty-five years ago, when the nation was embroiled in a world conflict whose aftermath and counterpart is raging today.

IMPACT OF MAJOR STATE TAXES ON DEFENSE ACTIVITIES

The present emergency found our state governments possessed of a great variety of taxes, many of them having originated in the depression years. Even identity or similarity in names does not imply equivalence or uniformity in tax bases. A classic example of this was New York City's "personal property tax" which was, in reality, a use tax enacted to reinforce the city sales tax. It is now called by its proper name.

Despite this variety, the state revenue derived from taxes

which rest on property, income, motor vehicle, motor fuel, or sales bases, appears to be that which will be most directly affected by the defense program, although the repercussions of the armament boom will be as multifarious as our economic life. Furthermore, the subject is confined to manageable proportions by this approach, rather than by any attempt to run the gamut of state taxes in general. It must not be overlooked, however, that state cooperation in such minor matters as the waiving of the poll tax on soldiers, and the relaxation of certain fee requirements, is part of any all-inclusive appraisal of present conditions.

Experience in the TVA territory has driven home the necessity for making amends to the states when large portions of the real property tax base are placed in exempt federal ownership. As the real estate holdings of the federal government continue to mount with the purchase and development of properties under the defense program, the need for assistance will become more acute. In some areas, the situation may approach catastrophic proportions as the demand for more governmental services rises while the tax base declines. Agitation for removal of federal immunity from state and local real estate taxes will become more insistent. Payments in lieu of taxes have been resorted to in the past, but the next few years will put this method to a sterner test. Perhaps considerably more experience is needed with this problem before a satisfactory solution is found. At any rate, it is on the agenda of defense tax problems.

State income taxes may rest on either gross or net bases. In New York State, the net income base predominates, although some of the corporation taxes are on a gross income or gross earnings basis. The corporation franchise tax, however, measured by net income is modeled closely after

the federal corporation income tax. When the federal government allowed a deduction for the amortization of defense plant costs, the New York State Tax Commission issued the following regulation under date of March 5, 1941:

The franchise tax on business corporations imposed by Article 9-A of the Tax Law is primarily measured by entire net income, which entire net income is presumably the same as that which the corporation is required to report for federal income tax purposes, with prescribed adjustments. Accordingly, in computing its entire net income for purposes of said franchise tax, a corporation is entitled to a deduction, for amortization of the cost of emergency facilities necessary in the interest of national defense, in an amount equal to that allowed to such corporation, for federal income tax purposes, under the provisions of section 23 (t) of the Internal Revenue Code.

By administrative ruling, the state of New York thus followed the lead of the federal government in a matter of extreme importance to corporations engaged in filling defense orders.

The New York State personal income tax, which is closely patterned after the federal individual income tax, has essentially the same base, the major exceptions being the absence of the earned income credit, \$2,500 and \$1,000 personal exemptions, and the separate taxation of capital gains at half the rates in force on other income. The taxation of income received by persons in the military service has been the subject of a special ruling of the Tax Commission, dated March 27, 1941.

Section 513 of the Federal Soldiers' and Sailors' Civil Relief Act of 1940 defers for a period extending not more than six months after the termination of any person's period of military service, the collection from him of any tax on his income if his ability to pay such tax is materially impaired by reason of such service. Section 102 of the Act makes it applicable to the several states. The Commission adopts and will be guided by the provisions of that Act in the treatment of income

tax liability to the state of New York of persons in the military or naval service of the United States. It will be the duty of any person desiring the benefits of the Act to file his return and request that payments thereon be deferred as the Civil Relief Act of 1940 provides, stating briefly the reasons why his ability to pay such a tax is materially impaired by reason of his military or naval service.

In addition to allowing a deferment until six months from the termination of military service in instances where taxpaying ability has been materially impaired, interest and penalties have not been imposed on persons in the military service. Income paid to nonresidents now in military service, by their employers located in New York, is subject to the customary withholding procedure.

Motor vehicle and motor fuel taxation is the keystone in the arch of many a state tax system, and in all states it possesses great fiscal importance. As the output of motor vehicles for civilian use is curtailed, and it now appears that such curtailment will be drastic, state revenue from motor vehicle registrations will suffer material losses, especially under property and license taxes based on market value, although this will be mitigated by rising car values. States in the category with New York which tax automobiles on a weight basis, and those employing horsepower ratings, will be less adversely affected because the use period of motor vehicles will be lengthened in the absence of replacements.

Motor fuel has an uncertain future for the duration of the emergency. Here, it has been alleged that the problem is one of transport rather than supply. While present transport facilities appear sufficient, the future is unpredictable, and should rationing occur for any cause, state revenues from this source may be expected to drop drastically with ensuing fiscal frustration where the gasoline tax is a major item.

Recent decisions of the United States Supreme Court have established the right of the states to tax sales made to cost-plus contractors. Sales of gasoline to such contractors will, therefore, be taxable to the states unless used for exempt purposes, or unless other factors intervene to prevent this from materializing, and will tend to offset revenue losses from declining civilian consumption.

Many states and some cities have enacted sales taxes, customarily imposed at the point of retail or sale to the ultimate consumer. Because the defense program is resulting in huge expenditures for plant, equipment, and countless individual items, these taxes, if imposed on defense purchases, would have a considerable effect on the program. The Supreme Court of the United States has recently handed down some decisions which are of tremendous significance in this connection. Hitherto, and perhaps one might say, still, the greatest confusion held sway among state officials, as evidenced by rulings and opinions concerning the taxation of materials sold to cost-plus contractors under prevailing state sales taxes.

The proposition that the states cannot tax the instrumentalities of the federal government, and vice versa, has already been stated. It is only necessary to establish the instrumentality classification in order to avoid the imposition of a state or city sales tax. A recent attempt to do this on the part of cost-plus-fixed fee contractors (*Alabama v. King and Boozer* and *Curry v. United States*) resulted in a ruling by the Supreme Court of the United States that such contractors are not immune from state sales tax levies. Although these cost-plus contracts customarily carry a provision whereby the federal government agrees to reimburse contractors for state and local taxes, it was argued that these contractors are instrumentalities of the federal

government and hence not liable for state sales taxes. But cost-plus contracts also carry another standard clause stating that contractors "shall make all contracts in their own name and not purport to bind the government or the controlling office thereunder." It is on this clause that the Supreme Court based its decision and upheld the states' contention that cost-plus-fixed fee contractors are in business for profit like anyone else holding a government contract and must, therefore, pay state sales taxes. The Supreme Court emphatically declared that these contractors are purchasers within the meaning of sales tax laws, and that they are not relieved of the liability to pay the tax because, in a "loose and general sense," they are acting for the government, or because the economic burden of the tax is shifted to the federal government. The doctrine of intergovernmental tax immunity received yet another nail in its coffin, when the court remarked:

So far as such a nondiscriminatory state tax upon the contractor enters into the cost of the materials to the Government, that is but a normal incident of the organization within the same territory of two independent taxing sovereignties. The asserted right of the one to be free of taxation by the other does not spell immunity from paying the added costs, attributable to the taxation of those who furnish supplies to the Government and who have been granted no tax immunity.

Unfortunately for any final, practical settlement of this problem, it is only necessary to change the form of the contract in order to renew the issue. Furthermore, federal contracting officers may take over the purchasing of materials, which is a step toward government force account construction and away from the employment of private enterprise on federal projects. Other methods of circumventing the decision, which have been receiving attention,

are to redraft the contract in such a way as to give these contractors explicit status as federal agents, or to have the contractors formally sell the material to the government. Finally, someone has remarked that considerable economic pressure might be brought to bear on behalf of the federal government by routing defense projects to those states cooperating with the federal government in matters of sales taxation. Cooperation, in this instance, means exempting such projects from state sales taxation or granting some form of preferential treatment.

So, while the states now have the right to impose sales taxes on cost-plus contractors, the authority conferred upon them by the courts must be exercised with prudence and discretion if the fruits of victory are not to be lost through circumvention and subterfuge. It has been estimated that the federal government may pay as much as \$100,000,000 in state sales taxes under the defense program, if the status of state sales taxation in relation to defense work is not altered by resort to one or more of the alternatives mentioned above.

Another aspect of state taxation of defense activities, primarily under sales taxes, is in connection with the Buck Resolution, which allowed the states to impose taxes on transactions occurring on federal reservations. The issue here has revolved around the question of whether sales made at post exchanges are properly subject to state taxation. In passing the resolution, Congress neglected to mention whether post exchanges are federal instrumentalities, thus, in reality, leaving the problem where it originated. State legal authorities and state courts have decided the question both ways. While some of the lower federal courts have held sales on post exchanges to be immune from state taxation, the Supreme Court of the United States has not

yet ruled on this important issue. As the result of legislation enacted in 1941, New York State now exempts from liquor and cigarette taxation sales made to unincorporated organizations of army and navy personnel operating a place for sale of goods pursuant to the regulations promulgated by the Secretaries of War and Navy. Gasoline sold by these organizations for nongovernmental uses is taxable to the state.

REVENUE ASPECTS OF STATE TAXATION OF DEFENSE ACTIVITIES

Review of the effect of taxing defense expenditures is really but half of a dual problem. There is a mutual relationship here which cannot be overlooked, for alterations in the pattern of economic life have profoundly affected the yields of state taxes. This development is now in its infancy, and the next few years are likely to witness many unforeseen eventualities.

The defense program has been accompanied by a prodigious expansion of industrial, commercial, and agricultural activity, together with the reduction of unemployment. State coffers have been greatly benefited by rising revenues while the costs of relief may be expected to decline. The stimulus of inflationary tendencies is abroad in the land and it will enhance the bases of those taxes which rest on surplus. For instance, the yield of the corporation franchise tax based on net income in New York State increased 40 per cent between the fiscal years 1940 and 1941. In all probability, it will show another great increase this year. New York does not allow the deduction of federal corporation income and excess profits taxes from the tax base, a fact which is extremely significant from a revenue standpoint. In those states which permit such a deduc-

tion, the responsiveness of the tax to changing economic conditions is dampened as the federal rates increase.

Neither does New York allow deduction of federal individual income taxes from taxable net income under the personal income tax. Were it otherwise, the deduction of federal individual income taxes, which rest on a steeply progressive rate structure, would decimate the tax base, and the results would be akin to those just cited for corporations.

A great hue and cry has been raised against the failure of many states, including New York, to allow the deduction of federal corporation and individual income tax payments from the base of their state counterparts, on the ground that it is double taxation. If the avoidance of "a tax on a tax" is the objective, then federal income tax payments made in one year should be deductible from the federal tax base the following year. The courts, recognizing our dual sovereignties, have not regarded the practice of state taxation on a federal base as unconstitutional, double taxation. Each government, federal and state, must have plenary taxing power if it is to retain its sovereign status. While the federal constitution contains those restraints required for a smooth-functioning federal system, this is far from denying the dual responsibilities of the taxpayer.

On the pragmatic side, the allowance of the deduction might finally result in a new rate structure more severe on the middle classes than its predecessor. Large incomes would be the chief beneficiaries of the deduction, and in a redistribution of the tax load to produce the same amount of revenue, the savings of the higher incomes would be in a considerable measure shifted to the lower income groups.

Rationing, priorities, allocation of supplies, and price control devices will inevitably have serious consequences

on the revenues from indirect taxation. As more and more of our national effort is diverted to arms and munitions, there will be an increasing supply of funds available for purchasing a decreasing supply of consumer goods and services, with the result that sales taxes will yield correspondingly less as the objects of sales taxation are removed from the scene. Some of this loss may be recovered in the form of taxes on federal disbursements, as already indicated, but, in the main, the prospect for a continuing expansion of the yield of indirect taxes during the next few years is not a rosy one.

PRINCIPLES OF DEFENSE TAXATION

In this hour of national emergency, both federal and state sovereignties have obligations to the nation, and to each other, which are an integral part of national unity, and their observances will be a prerequisite to the harmonious accomplishment of the national objective. On its part, the federal government must recognize the limited fields of taxation remaining to the states. These tax spheres will become more and more limited as expansion of the federal tax structure, under the pressure of defense financing, continues. More than ever before, it will be incumbent upon the federal government to refrain from infringing any further than is absolutely necessary upon those taxes generally regarded as the proper province of the states. Secondly, because of its dominant position and singleness of purpose, the federal government is in an unusually favorable position to promote and stimulate co-operation with state and local governments in integrating all the taxes into an equitable national tax system. It is high time that the taxpayer received this consideration to which he is so obviously entitled, if he is to bear up under

the severe tax burdens which lie just ahead. While this proposition is easier to state than to accomplish, it must be the guiding star of those who are seeking to coordinate, by centralization, segregation, or whatever means, an American system of taxation. Thirdly, because state governments realize the need for balanced budgets, it is generally felt that the federal government should endeavor to hold nondefense expenditures to the irreducible minimum, with a view toward eventual budgetary balance after the national emergency has passed. Finally, experience has taught that as large a proportion of the national expenditures as possible should be financed from current revenues, in order to avoid the inflation which is a concomitant of too rapid an expansion of the national debt.

On their part, the states also have definite obligations to the national weal. In the interests of the entire tax burden, they should refrain from enacting new and heavier taxes which would compete with, or foil, the efforts of the federal government to spread the tax burden more equitably. Cooperation with those forces and organizations which are seeking to promote the equity and universality of the tax structure is one of the means to this end. Secondly, states too should limit their expenditures to the irreducible minimum in order that the total tax burden may be kept within bounds; although on this point there are two schools of thought, one group believing that reduction of state and local debt is more important than tax reduction. In practice, a happy blending of these divergent views appears to be the best answer to the problem. Finally, the states should refrain from discriminatory taxation of defense activities and from constructing tax barriers to interstate commerce. While the states are entitled to those taxes on defense activities which accrue in the ordinary conduct of

affairs, any attempt to single out defense activities, or to embarrass the defense program with what appears to the neutral observer as objectionable taxation, will only rebound to the ultimate disadvantage of the states resorting to this practice. The burdensome taxation of interstate commerce needs no comment here.

Should the tax policies of the federal government and the states be motivated primarily by revenue or by regulatory objectives? Proponents of economic control by tax policy stress the need to bridle inflation by heavy taxation of income and by other taxes. While fiscal policy may be a helpful adjunct to the exercise of the police power, it is by no means a substitute for it. Furthermore, it is by nature no preventative of economic ills, because taxation accompanies or follows after them. By its very nature, it cannot precede them. Finally, so devious and complex are the problems of tax incidence, and so vague and uncertain the gauges of their measurement, that severe, unforeseen, and unwanted repercussions may flow from the imposition of a regulatory tax. Probably one of the best illustrations of this point was the experience with the undistributed profits tax. Chain store taxation offers another illustration of how taxation may promote uneconomic ends.

Unwise intermingling of restrictive measures and regulatory taxes may be the result of attempting to curtail consumption by both means simultaneously. For example, it is conceivable that automobile production might be held within the desired bounds by some form of rationing. On the other hand, heavy taxation of automotive sales, while it would retard purchasing, is subject to the charge that it promotes class conflicts by excluding the relatively indigent from the effective demand schedule, or by causing them to consume less of needed, life-sustaining commodities.

Failure to harmonize federal and state objectives may well be all but disastrous to the success of our preparedness program. Because of the perilous condition of world affairs, and because of the economic obligations which it has assumed during the depression years, the federal government today enjoys the preferred position in our governmental system of sovereignties. Nevertheless, if our system of government is to survive the shocks from within and from without which the next few years will bring it, it will require all the patient effort and loyal ingenuity of its patriotic citizens to overcome the obstacles which fortuitous events have cast upon us.

CHAPTER XIV

LOCAL TAXES AND IN-LIEU PAYMENTS

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THE POLICY of making payments in lieu of taxes to state and local governments on federally owned property is one of relatively recent growth, most of the developments having occurred during the past ten years. Among the better known examples are the provisions for payments on slum-clearance projects initiated by the Public Works Administration, on certain lands acquired by the Farm Security Administration, and the arrangements now in force for replacing taxes on power properties of the Tennessee Valley Authority. If the number of bills introduced in each session of Congress may be taken as a guide, we may expect rather rapid extension of the policy, as the federally owned property increases in volume.

LACK OF CONSISTENT POLICY

Despite the rapid increase in the use of in-lieu payments, the theory or philosophy underlying the practice is still in the formative stage. Most of the writing on the subject has been done by students of finance and constitutional law who have been concerned chiefly with the historical development of the doctrine of intergovernmental immunity from taxation. On the other hand, most of the legislation providing for in-lieu payments has been piecemeal in character, each act designed to meet a particular situation. The

arguments in support of the proposals have usually been advanced to show the need for immediate action, and do not, therefore, present a comprehensive or well-rounded philosophy.

The need for a consistent policy became apparent in the early days of the New Deal, when the varied activities of the federal government led to the acquisition of real estate on a large scale. A new approach to the problem of conservation and land-use planning resulted in the purchase of several millions of acres of submarginal land, chiefly in the West and South. This was accompanied by substantial purchases, in other sections, for establishment of subsistence homesteads and suburban resettlement projects of the Greenbelt type. In carrying out its program the Tennessee Valley Authority acquired thousands of acres of land for reservoir purposes, and later acquired entire electric power systems from private utility companies. As a part of the public works program, the Housing Division of the Public Works Administration initiated 49 slum-clearance projects, thus placing the United States government in the urban real estate business. Finally, it was apparent that the various federal lending agencies, such as the Farm Credit Administration, the Home Owners Loan Corporation, and the Reconstruction Finance Corporation, might acquire substantial holdings as the result of default of borrowers.

In some areas where federal acquisitions were substantial, local officials and taxpayers felt that continued existence of the local taxing districts was seriously threatened by the loss of tax revenues on federal lands. Accordingly, a variety of relief proposals appeared in Congress, some calling for specific grants-in-aid; some, for the right to tax federal properties; and others, for a share in the revenues derived from federal operations. Finally, the President

appointed a committee to assemble information on the extent of the federal holdings and the various practices being followed with respect to payments.¹ Following the report of this committee,² the President in 1939 created the Federal Real Estate Board, which, in addition to certain duties relating to the disposal of unused or "surplus" real estate owned by the federal government, was requested to "study, and make appropriate recommendations regarding, the situation in different communities adversely affected by the loss of tax revenue on land purchased or acquired by the federal government."³ As yet the Board has issued no formal report; whether it will attempt to develop an over-all formula for handling the problem, or will deal with each situation as a separate problem is not known.

CONDITIONS GIVING RISE TO IN-LIEU PAYMENTS

It is not my purpose in this discussion to attempt to develop an over-all formula, nor to present a complete philosophy justifying payments. In order to discuss the relationship of in-lieu payments to the defense program; however, it is necessary to sketch briefly some of the conditions that give rise to a demand for such payments.

Property owned by the federal government may be classified in a variety of ways. Perhaps the most obvious classification would show the purpose for which the property was acquired or is being held, or, better still, the way it is being used. The major subdivisions might well distinguish between property used for primary governmental functions,

¹ This committee was composed of the Secretary of the Treasury, the Attorney General, and the Acting Director of the Budget.

² Referred to the Committee on Public Buildings and Grounds, January 16, 1939, and published as *House Document No. 111*, U. S. 76th Congress, 1st Session.

³ *Executive Order 8034*, January 14, 1939.

such as office buildings, military posts and camps, naval yards, veterans hospitals, etc., and property used for commercial or semi-commercial activities, such as post offices, power properties, transportation facilities, etc. A second classification would show how the property was acquired, whether as a part of the original public domain or by purchase, construction, gift, or foreclosure. A third grouping would reveal the previous status of the property with respect to taxation; that is, whether the property was formerly on the tax books of state and local governments, or whether it is new wealth created or constructed by the federal government.

Although each of these classifications would be helpful in determining whether or not in-lieu payments should be made, it is believed that the third is most significant. Let us assume that the federal government acquires land which at the time of acquisition was subject to state or local taxation or both. The immediate result is a reduction in the tax base, with some loss in tax revenues. The extent or seriousness of the loss will be determined not merely by the amount of taxes formerly paid on the property being acquired, but by the size of the taxing district. Obviously, a loss in revenues that would completely wreck the finances of a school district, or even a county, might leave state revenues relatively unimpaired.

In the case of a local government, the need for relief or assistance may be either temporary or permanent. Suppose, for example, that a county has a large outstanding indebtedness, and that debt service charges absorb a substantial proportion of current revenues. If land is acquired in order to establish a national park, a forestry reserve, or for reservoir purposes, such acquisition may involve wholesale removal of population, thus decreasing the need for

county services, such as education, highways, and public health, yet the debt and its service charges continue. In such a case, it seems obviously unfair to saddle the remaining property owners with increased taxes to liquidate the indebtedness. The need for assistance is immediate, but if general operating costs have been reduced as a result of the federal acquisition, it is questionable whether in-lieu payments should be extended beyond the period required to extinguish the debt. The chief function of the payments, in this instance, is to cushion the shock resulting from an actual loss of revenues; we may assume that after a certain period the local unit should be able to readjust its services and operate successfully on its reduced revenues.

DIFFICULTIES IN DETERMINING BASES

The case for payments in lieu of taxes appears quite different when the federal government comes into an area and creates new wealth. Here, the reduction in tax base and the accompanying loss in local tax revenues is limited to the loss on the value of land and perhaps some attached structures that are demolished. Suppose that the value of the property acquired, chiefly land, is one million dollars, on which the government erects plants or structures valued at ten million dollars. If any payments in lieu of taxes are made, should they be based on the original value of the properties acquired, or on the new values created by the federal government? One line of argument asserts that the new values should be used, on the theory that the improved properties receive certain benefits and impose definite costs upon the local government. According to another theory, the values created by the federal government represent values that might otherwise have been created by private enterprise. The loss claimed in this case is not an actual

or historical loss, but a potential loss arising out of the inability to tax "what might have been." In determining whether in-lieu payments should be made, it seems essential that some effort be made to compare the additional costs imposed on the local government, by the existence of the federal property, with the benefits conferred on the people of the community. The chief difficulty, of course, is one of measurement. Is it possible to determine how much municipal costs have been increased by the presence of a navy yard, a munition plant, or a post office, in the community? On the other hand, how can we measure the benefits conferred by such activities? So long as local units are restricted to the property tax as the chief source of revenues, it will be difficult to persuade local officials that intangible benefits, which have not materialized in the form of taxable property, constitute a satisfactory offset to actual outlays for services on federally owned holdings.

At the time the defense program was instituted, it seemed that the fiscal problems arising out of federal ownership of real estate were in the process of solution. Either by choice or by force of circumstances, both Congress and the administration had tacitly admitted the need for payments in a wide variety of cases. The question of taxing low-rent housing projects was substantially solved when these projects were transferred in 1938 from the Housing Division of the PWA to the newly created United States Housing Authority, which in turn leased the majority of them to local housing authorities.⁴ At the end of June, 1940, these local authorities were making some payments in lieu of taxes on 35 of the 40 projects then under lease.⁵

⁴ By June, 1940, 40 of the 49 projects were so leased. *First Annual Report—Federal Works Agency, 1940*, p. 186.

⁵ *Ibid.*, pp. 390-96.

On projects operated directly by the federal government, the administrator is authorized to enter into agreements with states or subdivisions to make payments in lieu of taxes, such payments to be based upon the cost of public or municipal services supplied for the benefit of the project and its occupants.⁶

A second group of properties that presented difficulties consisted of those acquired under the successive and constantly changing phases of the resettlement program. The solution adopted by Congress was essentially the same as that applied to the low-rent housing projects; that is, the administrator was authorized to enter into agreements with states or local subdivisions, and receipts from both operations and appropriations were made available for making such payments.⁷

Finally, in 1940, the problem of compensating states and local units for tax losses resulting from TVA activities was settled temporarily, at least, by passage of the Norris-Sparkman bill, after extended and acrimonious discussion both in Congress and in the press. This bill provided for (1) an increase in the percentage of power revenues to be used for in-lieu payments; (2) a change in the method of computing power revenues, to which the percentage is to be applied; and (3) changes in the methods used in apportioning payments among the various states and local units.⁸

⁶ 49 Stat. 860 (Act of June 29, 1936).

⁷ 49 Stat. 868 (Act of June 29, 1936). According to the *Report of the Secretary of Agriculture* (1940), the Farm Security Administration in 1940 was completing and managing 162 homestead projects of many different types; in addition, there were 26 permanent camps for migrant workers, located in seven different states.

⁸ The legislative history of the TVA tax problems is traced by Alexander T. Edelman in an article appearing in the *American Political Science Review*, XXXV (August, 1941), 727-37. A more detailed statement of the operations under the Norris-Sparkman Act, together with a general

DEFENSE HOUSING AND IN-LIEU PAYMENTS

With the initiation of the defense program, the federal government was forced into the acquisition of real estate on a new and enlarged scale. Large acreages were required for training camps, flying fields, and firing ranges, and additional space had to be provided for expansion of shipyards, arsenals, and munition dumps. In addition, it was necessary in many instances to provide housing facilities for the employees required to construct and operate the new properties.

Although these new federal acquisitions have resulted in substantial tax losses in many communities, it is probable that the defense program has injured certain communities more seriously in other ways. One of the distinctive characteristics of the present defense program is that it has necessitated a wholesale redistribution of population in making the shift from a peace to a modern war economy. Rural and small town areas, such as Charlestown, Indiana, Milan, Tennessee, and scores of others, have boomed almost overnight into urbanized communities due to location of defense plants. In more highly developed areas, such as Portsmouth, Newport News, and Hampton Roads, Virginia, concentration of defense activities has resulted in an influx of population that has strained housing and general community facilities to the breaking point. These conditions may develop in areas where the federal government acquires no title to property; the injury to local governments is not to be measured by losses in tax revenues, but by the extraordinary expenditures required.

survey of the whole problem of tax equivalents is given by Lawrence L. Durisch and Herschel L. Macon in *The Journal of Politics*, III (August, 1941), 318-34.

As is generally known, the federal government has attempted to deal with these problems in two ways. First, it has assumed responsibility for providing housing facilities in case private initiative is unequal to the task. Such activities are not undertaken, however, for the purpose of assisting local governments, but simply to facilitate defense production. Second, under the Lanham Act it has granted financial assistance for the construction and operation of community facilities, such as schools, streets, water systems, sewage disposal plants, etc. Under the first procedure the federal government appears once more as an owner of real estate, and there is again a question of tax loss, which can be handled by some form of in-lieu payments. The second procedure is simply another type of federal loan or grant-in-aid, involving no tax loss, and calling for no payments in lieu of taxes.

The Lanham Bill (H. R. 4545), which was enacted in June, 1941, appropriated \$150,000,000 for public works and community facilities in national defense areas. Administration was placed in the hands of the Defense Public Works division of the Federal Works Agency. By the middle of September, applications totalled almost \$500,000,000,⁹ and by the end of October, 705 projects had been approved at an estimated cost of \$107,746,430.¹⁰ For some types of projects, such as recreation centers, it appears that the entire cost is borne by the federal government, while for others, either loans or outright grants are made to local governing bodies under procedures comparable to those followed by the earlier PWA. Although the bulk of the funds are used for construction purposes, the federal gov-

⁹ Wade S. Smith, "Defense Public Works Program Begins," *National Municipal Review*, XXX (October, 1941), 605-6.

¹⁰ *This Week in Defense* (October 31, 1941), Office of Government Reports.

ernment in some instances has assumed the cost of operating and maintaining certain facilities, particularly schools.

At the present stage it appears virtually impossible for an outsider to get a clear picture of defense housing activities. Apparently, at least eight different agencies are participating in the program.¹¹ A total of \$300,000,000 has been appropriated for defense housing projects under FWA, \$150,000,000 being made available in October, 1940, and the remainder in May, 1941.¹² An additional \$100,000,000 was made available to the Army and Navy in September, 1940, to provide family housing in defense areas, and another \$5,000,000 for "stop-gap" or emergency housing in March, 1941. It was reported, as of November 1, 1941, that funds had been allotted for 123,379 defense homes, and that 48,084 were then ready for occupancy.¹³ A report as of July 1, 1941, covering only the projects being administered by the USHA, shows that the 101 projects were concentrated in 25 states, all but four being eastern and southern states. Of the 23 states having no defense housing projects, five were east and 18 west of the Mississippi River.¹⁴

Since it was anticipated that defense houses would be occupied chiefly by workers in defense plants and by civilian employees of the Army and Navy who would be able to pay economic rentals, it was not considered neces-

¹¹ The President, on one occasion at least, allocated certain defense funds to housing projects, and these sums were deducted from specific appropriations made at a later date. Congress has made specific appropriations to designated agencies, such as the FWA, the Army and the Navy, and these agencies in some instances have transferred the funds to another organization. A certain project may be planned and initiated by one agency, then transferred to another for completion.

¹² Theodore A. Veenstra, "Defense Housing Policies and Progress," *Monthly Labor Review*, LII (May, 1941), 1061-78.

¹³ *Defense*, November 12, 1941.

¹⁴ *Public Housing*, II (July 25, 1941). (Weekly publication of the Federal Works Agency.)

sary to make special tax concessions similar to those adopted with respect to low-rent, slum-clearance projects. State and local governments, however, have not been given authority to tax such properties. Instead, the Federal Works Administrator was authorized to enter into agreements with state and local units, and make payments in lieu of taxes.¹⁵ In February, 1941, the Administrator announced the general policies that would be followed.¹⁶ It is understood that the minimum payment shall be an amount equal to the taxes levied on the property before it was acquired by the federal government, with provision for additional payments based on the value of services normally provided by the local governments. In accordance with the statute, the payments shall not exceed the taxes that would be paid on the property if it were not exempt from taxation. No information is available as to the number or details of the agreements that have been made.

POST-EMERGENCY PROBLEMS

Although these arrangements may prove satisfactory during the defense period, there is no assurance that they will be adequate when the emergency is ended. It is not likely that the federal government will enter the competitive market and continue to operate \$300,000,000 or \$400,000,000 worth of residential real estate; instead, efforts will probably be made to transfer the properties to local housing agencies for occupancy by low-income groups. Such transfers would mean a substantial reduction in the payments now being made, since the USHA has insisted that if any tax equivalents are to be paid by local housing authorities, they should be kept at a minimum in order that

¹⁵ Public Acts 849, U. S. 76th Congress.

¹⁶ *Defense*, February 25, 1941.

rents may be kept as low as possible. Under these conditions, local governments may become increasingly reluctant to assume control of the properties. Suppose, then, that the federal government retains full title to the defense homes, and that vacancy ratios rise sharply as defense activities are shut down. How long will the federal government be willing to continue making payments on vacant property? And will local governments willingly enter into agreements to accept in-lieu payments if they are to be computed as a percentage of depression rentals?

This discussion has been limited to payments in lieu of taxes. It will be realized, of course, that the impact of the defense program on local governments cannot be measured solely by tax losses on federally owned real estate. The effects of certain other types of impact cannot be remedied by in-lieu payments.

It is apparent, for example, that the tremendous increase in federal taxes will absorb larger and larger shares of individual incomes. As individual spending habits are adjusted, there may be some decrease in purchases of taxed commodities and services, thus lowering tax collections from these sources. Thus, revenues from motor vehicle and gasoline taxes may decline, due in part to the reduction in the output of new cars as the priorities system tightens up. States that rely heavily upon sales taxes may be affected differently, depending upon the scope or coverage of the tax. For example, revenues from a sales tax that includes foods and other essentials may prove more stable than those from a tax that excludes such commodities.

It is true, of course, that relatively few local units make use of taxes on commodities or sales. To the extent, however, that the state draws upon such revenues for its grants-in-aid, or permits local units to share in the state

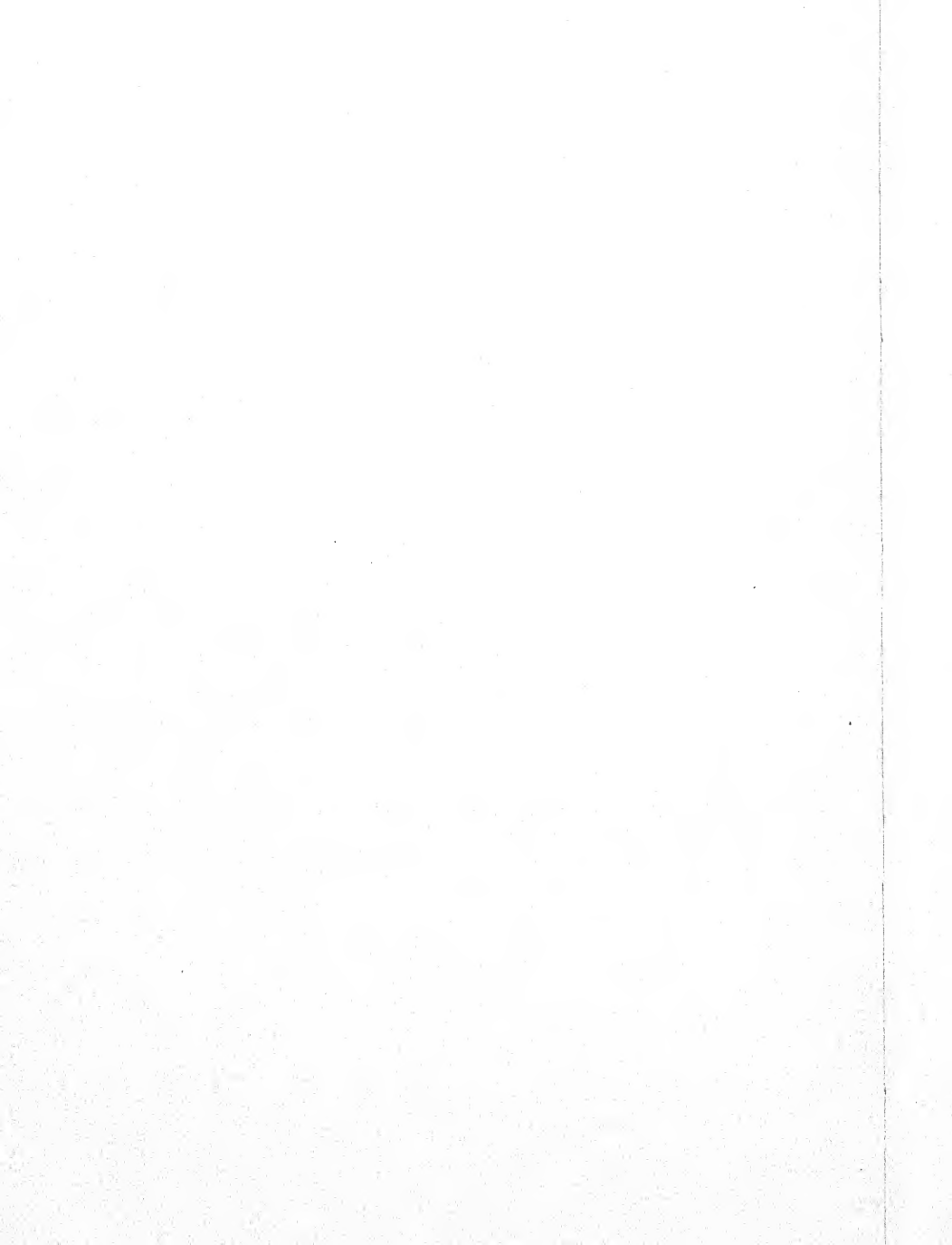
collections on a percentage basis, local revenues will be affected adversely.

Both state and local governments may suffer from another type of impact, arising out of the more strategic position of the federal government as a tax-gatherer. In normal times it seems that taxpayers have greater respect for (or perhaps fear of) the federal government than for either states or local units, due possibly to the more vigorous and efficient federal collection methods. In a national emergency, this feeling may be strengthened. If it becomes necessary for the taxpayer to postpone or default on his tax obligations, revenues of the state and local units will probably be more seriously affected than those of the national government.

It is probable that the majority of local units up to the present have gained more than they have lost as a result of defense activities. With the volume of employment and national income expanding, real estate values tend to rise. These increased values are gradually being placed on the tax rolls, thus enlarging the local tax base. In the meantime, increased incomes should lead to the liquidation of accumulated tax delinquency, and should also result in improved collections on current levies. If these favorable conditions prove to be short-lived, it will represent another impact of the defense program, and one that cannot be remedied by in-lieu payments.

PART FIVE

DEFENSE AND WAR REVENUES IN OTHER COUNTRIES



CHAPTER XV

HOW BRITAIN IS AVOIDING INFLATION

BRINLEY THOMAS

British Embassy

THIS WAR IS having a revolutionary effect on some of our old British institutions, and one of these is the budget speech. The Chancellor of the Exchequer has always regarded it as his job to deal with the outlays and revenues of the central government; he has not hitherto thought it necessary to worry about such concepts as the national income, savings, and investment. These things used to be regarded by most politicians as the playthings of academic economists. But now consider these words:

I do not believe that the difference between total expenditure and Budget revenue has so far introduced inflationary dangers into our system . . . My judgment seems to be fortified by the results of a number of difficult and complicated statistical calculations which have been made available for my consideration. This material consists in part of an attempt made by the Treasury to analyse statistically the sources of war finance and in part of tables of national income and expenditure, which are the very valuable first fruits of our new Central Statistical Office set up by the Prime Minister, an office which now assembles for the information of the War Cabinet and Government Departments regular series of statistics which, though many of them are of necessity secret, are more conclusive than those which we have hitherto possessed. I have decided, after a good deal of consideration, to present to the Committee the statistical analysis to which I have just referred and it will be available at the end of my speech as a White Paper additional to the ordinary Financial Statement which is published at this moment every year, and I hope that the Committee will welcome this new departure. It may seem strange that we should publish in time of war fuller information than in time of peace, but for

one thing our tasks require a more comprehensive knowledge, and secondly we do know more because a much larger part of the national economic life falls within the purview of Government Departments.

Those were the words of Sir Kingsley Wood in his budget speech in the House of Commons on April 7th, 1941; and they constitute an important landmark. The title of the White Paper is *An Analysis of the Sources of War Finance and an Estimate of the National Income and Expenditure in 1938 and 1940*. The problem of war finance embraces far more than what is ordinarily regarded as the government's accounts; and its solution can come only from a policy framed in terms of the *nation's* income and expenditure, and not merely the government's receipts and outlays. This new approach will also be invaluable when the problems of postwar readjustment will crowd upon us, when statesmen will be called on to satisfy the insistent demand for full employment of human and material resources.

THE EVOLUTION OF A WAR ECONOMY

In order to lead up to the subject of how Britain's war effort is being financed, I propose to sketch very briefly the stages through which a nation has to go in its effort to turn itself into a fully fledged war economy.

Phase One: Unemployed resources being absorbed

When a country embarks on a rearmament program, a new stimulus to investment comes into play. The first effect of this is to reabsorb unemployed men and idle plants, and there is a corresponding rise in the nation's real income. If the country starts off with a fairly large volume of unemployment, it is natural that in this first stage there should be a sharp increase both in the production of goods

for civilian consumption and of armaments. The wages of the more highly skilled workers may rise here and there, but, on the whole, what happens is that more goods and services are being produced without much change in the price level.

Phase Two: Full employment, with the transference of men and resources from the Peace Sector into the War Sector still proceeding

At the beginning of this second phase, practically all workers, except those who are unemployable or in the act of moving from one job to another, are in employment, but they are distributed over various industries and occupations in a manner very different from what the war effort requires. The problem in this second phase is to secure a rapid transfer of labor and equipment out of peace employment into war production, while at the same time tapping new sources of labor, such as women and retired persons. If this is to be achieved without the distortion of prices, it means that, as the part of the national income used by the government rises, the proportion spent by the public on itself must fall.

Phase Three: Full employment, with the optimum transfer of men and resources into the War Sector achieved

In this phase the war economy has reached its maturity. There is some optimum proportion of the real income of the community which the government must obtain if it is to put forth a full war effort. A democratic government has to devise ways and means of inducing the public to release its peacetime grip on the country's productive resources as quickly as possible. We must keep our minds on the real facts. It is labor, raw materials, and equipment

that the government must have, and the object of war budgets and victory loan campaigns is to engineer their transfer from peacetime to wartime uses. When the limit of transfer has been reached, the problem of policy is then to see that this maximum level of effectiveness is maintained.

It is worth mentioning in passing that in certain circumstances, such as a movement in the rate of exchange, there can be a sharp rise in the wholesale price level even during Phase One. For example, in England at the beginning of the war, the fall in the external value of sterling, through its effect on the price of imports, led to a substantial increase in the internal price level.

Fiscal Measures and Quantitative Controls

In its campaign to push forward to Phase Three, the government must operate on several fronts. All this can be summed up under two heads: fiscal policy and quantitative controls.

Fiscal measures operate *indirectly* on consumption and production by influencing the use which people make of their money: e.g., taxation, war savings, mobilization of foreign assets, price decrees, foreign exchange regulations.

Quantitative controls operate *directly* on the amounts produced and consumed, e.g., rationing of consumers' goods, limitation of supplies, priorities, import and export restrictions, requisitioning of factories and sites, concentration and pooling of industry, direct transfers and dilution of labor.

It is natural for a democracy to begin by relying heavily on fiscal or budgetary measures; but in this war these are quite inadequate by themselves. The British Chancellor of the Exchequer pointed out in his budget speech of April 7,

1941, that "the problems inherent in the most expensive war in history . . . cannot be solved by purely financial means. There can be no single approach to the problems of a total war economy." It is the lesson of British experience that, if a democratic war economy is to move successfully through Phase Two, it must lay increasingly more stress on direct controls and less on fiscal policy.

THE SOURCES OF BRITAIN'S WAR FINANCE

Britain was in Phase One until the latter part of 1940, and we may regard the swift course of events on the home front since then as characteristic of Phase Two.

Let us glance at the first year and a half of the war, i.e., September, 1939, to February, 1941, using the figures set out in the White Paper, *An Analysis of the Sources of War Finance and an Estimate of the National Income and Expenditure in 1938 and 1940*. The fiscal position is summarized in Table 1.

TABLE 1
UNITED KINGDOM GOVERNMENT FINANCE

Source of Funds	Year 1938	First Year of War	First Half of Second Year of War
Taxation	£ 942,000,000	£1,288,000,000	£ 817,000,000
Extra-budgetary receipts of public departments . . . . .	...	113,000,000	90,000,000
Overseas sources . . . . .	...	542,000,000	479,000,000
Savings of local authorities, institutions, and undistributed profits of companies . .	...	272,000,000	131,000,000
Reinvestment of sums realized from domestic capital assets plus net personal savings . .	...	382,000,000	557,000,000
Government expenditure . .	£1,004,000,000 ^a	£2,597,000,000	£2,074,000,000

* Including £62,000,000 from savings.

In the first year of the war,

1. Fifty per cent of government expenditure was financed out of taxation;
2. Over one-fifth of government expenditure was financed by drawing on foreign assets, the amount raised being £542,000,000, or \$2,168,000,000;
3. Private and corporate savings (including extra-budgetary receipts of public departments) plus realization of domestic assets, accounted for about 30 per cent of government expenditure;
4. Government expenditure was over $2\frac{1}{2}$ times what it was in 1938.

In the first half of the second year,

1. Just under 40 per cent of government expenditure was financed out of taxation;
2. About 24 per cent, or £479,000,000 (\$1,916,000,000) came from overseas sources;
3. Personal and corporate savings plus realization of domestic assets contributed 36 per cent;
4. At an annual rate government expenditure was $4\frac{1}{4}$ times what it was in 1938.

The rate at which Britain was consuming her overseas resources in the first eighteen months of the war was considerable, the total being £1,021,000,000, or \$4,084,000,000. Clearly it was physically impossible for this to go on for much longer. The depletion of domestic capital was relatively much smaller.

It is interesting to note that the proceeds of the sale of certain domestic capital assets yielded £240,000,000 in the first half of the second year, compared with £60,000,000 in the first year. Net personal savings have shown an encouraging buoyancy, constituting £320,000,000 in the first year of the war and the same sum in the first six months of the second year. The great spurt in the British war effort in the second half of 1940 is clearly brought out in the above figures.

The War Effort in Real Terms

The figures used by the White Paper reflect current prices and, therefore, do not take into account the change in the value of money. In order to get at the war effort in real terms, it is necessary to express these figures in terms of prewar prices. The results can, of course, be merely an approximation. I shall quote the estimates given by Nicholas Kaldor in the *Economic Journal*, June-September, 1941.

TABLE 2

SOURCES OF BRITISH WAR FINANCE IN REAL TERMS ^a
(In annual rates, at prewar prices)

Increased government expenditure in 4th quarter, 1940, compared with 1938.....	£2,550,000,000
Reduction in consumption.....	350,000,000
Increase in output.....	450,000,000
Increase in adverse balance.....	950,000,000
Reduction in private long-term home investment.....	550,000,000
Depletion of privately owned stocks.....	250,000,000

^a Calculated to the nearest 50 million pounds.

BALANCING THE 1941-42 BUDGET

The Chancellor of the Exchequer devoted a good part of his speech on April 7, 1941, to what he called the "potential inflationary gap." "The national accounts," he said, "will always balance, and it is only in so far as they are balanced otherwise than by the results of taxation, plus other Exchequer aids and resources, plus genuine savings, that the danger of inflation will arise."

It will now be convenient to turn to the fiscal year 1941-42, and to consider the current expansion in the war effort and the adequacy of the methods adopted to avoid inflation.

The estimated expenditures for the fiscal year 1941-42 do not include the value of supplies obtained from the United States under the Lend-Lease Act or the payments to be made in the United States under existing orders. The total expenditure contemplated for the year is £4,207,000,000, of which Civil Supply services account for £435,000,000, the fixed debt charge £255,000,000, and other consolidated fund services £17,000,000. After allowing for outlays which will be met out of the sterling balances of the Dominions and other countries accumulating in London, total *domestic* expenditure is estimated at £3,700,000,000, as compared with the corresponding figure of £2,055,000,000 in the first year of the war, and an annual rate of £3,190,000,000 in the first half of the second year of the war.

British *domestic* expenditure in 1941-42 is thus 80 per cent higher than it was in the first year of the war.

On the basis of 1940-41 tax rates, the yield of taxation for 1941-42 was put at £1,636,000,000, of which income tax makes up £605,000,000, surtax £80,000,000, excess profits tax and national defense contribution £210,000,000, customs and excise £578,000,000, the purchase tax £70,000,000. This leaves a difference of £2,064,000,000 between expenditure and revenue. If savings and similar receipts flowed in at the 1940-41 rate, a sum of £1,600,000,000 would result. Assuming an increase of savings by between £200,000,000 and £300,000,000, the difference between expenditure and revenue would be narrowed to about £250,000,000.

The Chancellor accordingly raised the standard rate of income tax from 8/6 to 10/- in the pound, and the rate on the first £165 of taxable income was placed at 6/6 in the pound. The earned income allowance and the personal allowance (for married persons) were reduced. The effect of these changes was to bring two million persons from the

lower income brackets within the scope of income tax. The incidence of direct taxation in England now may be shown by the fact that in order to enjoy a net income of £5,000 a year it is necessary to have a gross income of £65,000, and for every pound sterling of income above that level only 6 pence or $2\frac{1}{2}$ per cent accrues to the recipient, thus making it very difficult for incomes net of tax to rise above £5,000 a year. These changes in tax rates are expected to yield the £250,000,000 required to close the estimated fiscal gap.

A modified version of the Keynes plan was inserted, whereby the new taxes paid by people in respect of the reduction of the personal and earned income allowances will be paid back in the form of a Post Office Savings Bank credit after the war (with a maximum of £65 per person on tax payable in 1941-42). Moreover, 20 per cent of the sums collected from the 100 per cent excess profits tax will be refunded after the war, subject to conditions to be laid down by Parliament.

BRIDGING THE "INFLATIONARY GAP"

We have seen how the Chancellor expects to balance his budget for 1941-42. Two important questions remain: Is there an "inflationary gap" which is not being filled by *genuine* savings or other resources? How far has Britain to go to reach her maximum war effort, i.e., Phase Three?

The Chancellor of the Exchequer, speaking in the House of Commons on October 1, answered the first of these questions in the following words: "From such indications as are available I think we may say that the objects set before the country six months ago to finance the war by methods which would hold dangers of inflation in check have been achieved. The danger remains, however, and there can be no relaxation." He stated that total government expendi-

ture in the first two years of the war was £7,018,000,000, of which £5,668,000,000 was for war outlays. Forty per cent of this enormous war expenditure was defrayed out of current revenues.

Does not the considerable expansion of bank credit since the beginning of the war contradict the Chancellor's claim? For example, the September, 1941, return reported an increase in the deposits of the London clearing banks of £838,000,000, or 37 per cent, over the average for 1938. In the same period, the amount of credit derived by the Treasury from clearing banks' holdings of gilt-edged securities, Treasury bills, and Treasury deposit receipts rose by £868,000,000. Is not this a clear symptom of inflation? Are the funds that the government is absorbing genuine savings, or are they in part created by the banks?

To answer this question I propose to draw a dividing line at the first quarter of 1941, by which time the normal labor supply in Britain was almost fully employed. The increase in bank deposits between 1938 and the first quarter of 1941 was £466,000,000. This was the period when England reached the end of Phase One, the number of wholly unemployed men falling from 951,000 in August, 1939, to 237,000 in March, 1941. It is safe to say that a large part of the expansion in the volume of money up to the beginning of 1941, reflected in the bank deposit figures, was the necessary accompaniment of the higher level of activity due to the taking up of slack. A greater real output naturally calls for a larger stream of money.

But this was not the whole story. The rise in wholesale prices in the first year of the war from 105 to 141 (about 34 per cent), the fact that new bank credit was created to the tune of about one-ninth of current requirements, and that the value of retail sales in August, 1940, was 11 per

cent higher than in August, 1939, were symptoms of a moderate degree of inflation. One reason for the sharp rise in the price level was the decline of the dollar-sterling rate of exchange to 4.03. It seems clear, however, from the increase in retail trade, that civilian consumption was being maintained at a level which reflected a competition between the public and the government for available resources. This moderate dose of inflation would have been serious if it had become habit forming; but, fortunately, it acted as a stimulant without leading to inebriation. In fact, the second year of the war witnessed a remarkable sobering down. The transition from Phase One to Phase Two may be summarized in Table 3.

The picture revealed by the figures for the second year of the war is reassuring. The cost of living has remained practically stable during 1941, while wholesale prices went up by only 2 per cent between March and September—in marked contrast to what occurred in the previous year. The key is found in the restriction of consumers' expenditure. Despite the considerable expansion of 510 million pounds or 21 per cent, in available money income in the form of bank deposits between June-August, 1940, and June-August, 1941, the value of retail sales went down by 5 per cent in this period. If we allow for the rise in the cost of living, the *real* cut in civilian consumption was about 13 per cent.

Another way of putting this is that the rise in the volume of money has been offset by a decline in its velocity of circulation. Instead of spending as they used to, people are paying heavy taxes and holding a good proportion of their money in the form of government bonds. The amount subscribed to Post Office and Trustee Savings Bank deposits, government securities on Post Office Register, and

National Savings Certificates was well over 900 million pounds between July, 1939, and July, 1941; and of this, no less than about 600 million pounds was contributed during the second half of this period. Sir Kingsley Wood paid

TABLE 3

TRANSITION FROM PHASE ONE TO PHASE TWO IN UNITED KINGDOM

	Bank Deposits	Whole- sale Prices ^a (1930 = 100)	Cost of Living ^b (July 1914 = 100)	Value of Retail Trade ^c (1937 = 100)	Estimated Retail Trade in Real Terms (3 Month Average)
1939 Aug.	£2,245,000,000	98.1	155	94	...
Nov.	2,345,000,000	117.2	169	103	...
1940 Feb.	2,366,000,000	123.6	177	95	...
May	2,413,000,000	133.7	180	115	...
June	2,469,000,000	134.4	181	105	...
July	2,454,000,000	139.7	187	113	100
Aug.	2,481,000,000	140.1	185	104	...
Nov.	2,702,000,000	146.9	192	104	...
1941 Feb.	2,709,000,000	150.0	197	98	...
May	2,824,000,000	151.3	200	111	...
June	2,946,000,000	152.4	200	106	...
July	2,991,000,000	153.2	199	101	87 ^d
Aug.	2,997,000,000	153.2	199	98	...
Sept.	3,115,000,000	154.3	199	^e	...

^a Board of trade index.

^b Ministry of Labour index.

^c Bank of England index.

^d The June-August, 1941 average value of retail trade expressed at the price level (i.e., cost of living) prevailing in June-August, 1940.

^e No figure available at time of writing.

a warm tribute in his statement of October 1, 1941, to the extent to which the people, particularly in the lower income brackets, have been putting purchasing power at the disposal of the government by investing liberally in small savings bonds.

Though the amount of money in circulation has greatly

increased, "the Government and the public," to use the words of the London *Economist*, "are spending no more (or only a little more) than the value at present prices of the goods and services available for consumption."¹ That is the acid test. There will be no inflation as long as the people are willing to transfer from their own bank accounts to the government's account in taxes and loans enough to enable their government to finance its full war effort without having to create new money. It is the very essence of a democratic government that it can achieve this difficult goal by appealing to the sense of responsibility of free citizens.

To sum up, the main reason why the menace of inflation has, so far, been checked in England is to be sought in the joint operation of spontaneous and governmental curbs on civilian consumption. Another factor is that, thanks to the United States, lend-lease supplies are being made available without Britain having to pay for them out of her *present* resources. It is estimated that if these supplies planned for the present fiscal year are added to British domestic expenditure, the grand total outlay comes to well over five billion pounds.

The quantitative controls mentioned earlier are playing an important part. Moreover, it is the policy of the government to peg the retail price level; and the Ministry of Food is spending 100 million pounds a year to cover trading losses on this account. This greatly reduces the pressure tending to drive wages up. So far, this policy can be said to have succeeded, for wage rates, according to Professor Bowley's index, rose by only 8 per cent in the year ending July, 1941, and the rate of increase in the last six months of that year was as low as 2 per cent.

¹ June 21, 1941.

There is, however, no room for complacency. There are one or two signs that "potential inflation" exists, e.g., runs on unrationed goods, black markets in certain commodities, and some speculation in land. But these need not prove more than superficial phenomena provided that wages and the commodity price level do not move out of balance.

IS BRITAIN NEAR HER MAXIMUM WAR EFFORT?

The last question may be dealt with briefly. Is Britain near her maximum war effort? Clearly, since she has had full employment for some time, the scope for further increases in real output is limited. It has been estimated that at the optimum level of war effectiveness, Britain will have cut her consumption by about 25 per cent and increased her real output by about 18 per cent compared with 1938; and that point may be reached sometime in 1942.

The national income of Britain in the fiscal year 1941-42 is authoritatively estimated at £6,000,000,000. It is as well to mention here, incidentally, that the burden on the British people in the current fiscal year consists not only of national taxes (£1,760,000,000), but also local taxes (£220,000,000), and health and unemployment insurance, contributory pensions, and war damage insurance (£420,000,000). Total taxation and analogous levies in Britain are, therefore, 40 per cent of the national income.

It is thus probable that in the course of 1942, Britain will reach the third phase in which she will be putting forth a full war effort. Domestic expenditure in one year at the level of £3,700,000,000 (over half the British national debt at the end of the last war!) is about 60 per cent of the estimated national income. This must be pretty near the optimum proportion, judged by the necessity of sustaining the effort perhaps for several years, though, of course, any

further net release in productive energies will mean a corresponding increase in the national income.

The prophets of woe, who paint a lurid picture of the country being bled white by the effort of financing a war effort on this vast scale, are ignorant of the elementary principles of a war economy. "The dangers of the future," to quote the British Chancellor of the Exchequer, "will not lie in the drying up of incomes but in the faltering of our resolution to restrict the spending of it. I firmly believe that the people have the same quiet confidence in the financial as in the military future of the war."

CHAPTER XVI

CANADIAN WAR FINANCE

WILLIAM H. WYNNE *

National Resources Planning Board

IN WARTIME, the economy of a country must be adapted to the production of huge supplies of armaments and munitions. As long as there remains a supply of unemployed or underemployed labor and idle or underutilized capital equipment capable of being turned to war production, and as long as no shortages develop in essential raw materials, the output of war goods may be expanded without any appreciable interference with the provision of nonmilitary goods and services. It may even be possible for a time to expand nonmilitary as well as military output. But once the reserves of labor power and capital equipment have been practically absorbed, further expansion in the output of war supplies can be secured only by diverting instruments of production from nonmilitary to military uses.

The process of taking up the slack in industry may be accelerated by governmental borrowing from the banks, for the new money thereby pumped into circulation provides a stimulant to the economy. If kept within moderate limits, the borrowing may serve this purpose without engendering a price inflation. But when the productive resources of the country have been brought into something approaching full employment and it becomes necessary to

* Member of the research staff of the Canadian Royal Commission on Dominion-Provincial Relations, 1937-38.

curtail nonmilitary production in order to expand the output of war materials, continued financing by bank loans would have different consequences. It obviously could not promote any further increase in production. It would simply tend to swell the aggregate spendable income of the people while the production of goods for civilian consumption was diminishing. The result, at least in the absence of an effective system of over-all price control, would inevitably be inflation.

Inflation is, of course, only an indirect form of taxation, but it is the most inequitable form of taxation. It hits hardest those whose money incomes remain fixed or rise least in relation to prices. The impact is likely, therefore, to be greatest not on the rich, but on the poor and middle classes. Moreover, as it progresses, inflation is likely to distort price relationships, provoke industrial friction, and damage public morale to a degree which may seriously hamper production. In a prolonged war, some degree of inflation may prove unavoidable, but it must, as far as possible, be rigorously checked and controlled, for once allowed to get out of hand it quickly becomes cumulative.

If when the stage of full employment has been reached the government is to refrain from inflationary bank borrowing, it must be able to finance its needs by taxation supplemented only by borrowing from nonbanking corporations, such as insurance companies, and the general public. But even though the government secures its loans directly from the public instead of from the banks, some price inflation may still ensue. A person may obtain the funds for the purchase of a government bond by selling another bond, securing an advance from his bank, or by drawing on an idle bank balance, and none of these procedures may interfere with his customary expenditures. Only in so far as

people save more in order to subscribe, that is spend less, can loans raised from the public be relied upon to prove non-inflationary. If inflation is to be avoided it is necessary, in short, for the government to abstract from the total income of the public, by taxation or borrowing, an amount approximately equivalent to what it spends for war purposes.

Because loans may come only in part from new savings, taxation is a more effective weapon than borrowing for cutting down civilian spending, and, therefore, a stronger safeguard against price inflation. Loans do not make taxation unnecessary, they merely spread it out over a period of time. When a given sum is raised by taxation there is but a single levy, and the burden is distributed among the different income groups in the nation there and then. If the same sum is raised by loan finance, an equivalent amount, augmented by the aggregate interest charges, must ultimately be secured by taxes in order to fulfill the loan contract, but the necessary taxes need be raised only in a series of annual installments instead of at once. The total tax burden will correspondingly be distributed piecemeal instead of at one time. But the higher the war debt is piled up, the heavier will taxation have to be after the war to service it.

Postwar taxation will have to provide not merely for debt charges, but for the enormous cost of reconstruction, war pensions, etc., and this too, perhaps, in the midst of a severe business depression. It is easier to impose drastic taxation in wartime, when people can be keyed up to bear great sacrifices, than it is in peacetime, and, therefore, if the postwar tax burden is to be bearable, the debt charges to be carried forward from the war to the postwar period should be kept as moderate as possible. Some war

borrowing there must be, for even in war there is a limit to the amount which the government can take from the public by taxation without producing unwillingness to work to capacity, discouraging enterprise, and provoking serious discontent. Just where this limit would be reached, under given circumstances, one cannot say. But the conclusion is warranted that a country at war can and should push taxation very far, much further indeed than any country did in the last war.

The essential task of war finance, then, is to help channel the human and material resources of the nation into the production of war goods and services as far and as fast as the scale of the conflict may necessitate. If this task is to be performed as effectively as possible and the financial burden of war distributed equitably, the needed money must be raised in such a way as to avoid any serious inflation. This means that after the stage of full employment has been practically attained, the government must refrain from paying any appreciable part of its way by the emission of new currency or the creation of new bank deposits, and rely exclusively, or almost so, upon taxation supplemented by loans drawn from new savings.

CANADIAN WARTIME FISCAL POLICY

The Canadian government has from the beginning endeavored to shape its wartime fiscal policy in accordance with the principles just reviewed.

That policy was adumbrated by the Minister of Finance in the first budget speech of the war (September 12, 1939) in the following terms:

We shall follow as far as may be practicable a pay-as-you-go policy. . . . We shall insist on the principle of equality of sacrifice on the basis of ability to pay. . . . As the first necessity is to win the war

as quickly as possible and without undue cost, we cannot carry taxes beyond the point where they seriously interfere with production. But we are not prepared to be timid or lighthearted in judging where this point lies, if need arises. What we cannot meet by taxation we shall finance by means of borrowing from the Canadian public at rates as low as possible.

He pointed out, however, that in the early stages of the war "a small and carefully regulated amount of credit expansion" would be desirable "in order to assist the increase of production and employment," and that "only after the initial period of expansion" was "well under way" would it be wise or profitable to attempt "any large borrowing operation designed to draw heavily upon public savings."

It was clear from the levels at which the indexes of business, production, and employment stood at the outbreak of war that there was considerable slack in many parts of the Canadian economy. The first war budget provided, therefore, for only moderate increases in taxation, and left immediate war expenditure needs to be financed mainly by a short term loan of 200 million dollars from the banks. The war expansion was rapid, and early in 1940 the first public loan (also for 200 millions) was issued and readily subscribed. To take toll of the rising national income additional taxes were imposed by the second war budget (June, 1940), and three months later a second public loan was marketed (for 300 millions). But subscriptions came in more slowly than for the first loan, and it seemed expedient to allow the public a fair breathing space before floating another issue. Early in 1941, therefore, the government again turned to the banks. Capacity production had not yet been fully reached and the 250 million dollar short-term bank loan then raised had no measurable inflationary consequences. The third war budget (April, 1941) again sharply increased taxation. Within a few weeks (in June,

1941) a third public loan—the Victory Loan—was launched, with a minimum objective of 600 million dollars, a goal high enough to ensure that increased saving would be necessary to attain it. A nation-wide campaign organization stirred the public up to so gratifying a response that subscriptions poured in from nearly a million persons, yielding in new money (i.e., excluding conversion subscriptions) no less than 730 million dollars.

To supplement these borrowing operations the government, in May, 1940, began the issue of war savings certificates. These have a face value of from \$5 to \$100 and may be purchased by the accumulation of 25¢ war savings stamps. They are thus designed to appeal especially to persons of moderate and small means (individual purchases are limited to \$600 a year) and constitute, therefore, a useful device for at one and the same time raising money and inducing people to curtail spending. The sale of these certificates provided in the fiscal year 1940-41, 52 million dollars. In the current fiscal year, it is hoped to realize at least 120 millions.

Fiscal measures alone cannot be relied upon to prevent civilian spending from militating against the war effort and to stave off price inflation. These have had to be accompanied by numerous direct controls, notably over foreign exchange, imports and exports, the use of many materials (priorities), wages and prices. Of particular interest to this country are the controls over wages and prices which have recently been extended to almost every industry and every kind of commodity transaction, but discussion of any of these nonfiscal controls is outside the scope of this paper.

Besides financing her own direct war needs, Canada has had to finance that growing part of her exports to Great Britain for which the latter has been unable to pay either

by exporting to the Dominion goods, services, or gold, or by providing the Dominion, in exchange for sterling claims, with United States dollars which the Dominion could apply towards the settlement of its current account indebtedness to the United States. To the extent that Canada's favorable current account balance with Great Britain has not been settled by these means, the Dominion government has had to provide Canadian exporters with Canadian dollars secured from the public through taxation or borrowing. The Dominion has thereby been accumulating large sterling balances in London. Part of these have been applied to the purchase of Canadian securities held in London, thus replacing debts payable in sterling with equivalent debts payable in domestic currency; the remaining sterling balances represent simply a loan to Great Britain. The amount Canada will need to raise in the current fiscal year to meet Great Britain's dollar deficit is expected to reach 900 million dollars, a sum equal to more than 60 per cent of the Dominion's own direct war expenditure.

The financing of the war, it may be noted, is solely the responsibility of the Dominion government. No part of the financial burden has been thrown upon the provinces or the municipalities, and provincial taxation has remained virtually unchanged. The development of Dominion war finance is clearly shown by the table which follows. The arrangement enables comparisons to be made between the finances of each of the two full years of war and those of the year immediately preceding the war.

WARTIME TAX DEVELOPMENTS

Nonwar expenditure has been kept down while war expenditure has grown rapidly. Before the war, expenditure on defense amounted to a mere one per cent of the national

TABLE 1
DOMINION GOVERNMENT FINANCE

Classification	Last Year before War Ending August 31, 1939	First Year of War Ending August 31, 1940	Second Year of War Ending August 31, 1941 (Preliminary)	Estimates for Fiscal Year Ending March 31, 1942
CASH REQUIREMENTS:				
Dominion nonwar expenditure	\$524,000,000	\$496,000,000	\$444,000,000	\$470,000,000
Dominion direct war expenditure.....	36,000,000	325,000,000	1,034,000,000	1,450,000,000
Financing of Britain's Canadian dollar deficit.....	.....	165,000,000	735,000,000	900,000,000
Total.....	\$560,000,000	\$986,000,000	\$2,213,000,000	\$2,820,000,000
MAJOR SOURCES OF FINANCING:				
Income tax on individuals plus National Defense Tax.....	\$ 56,000,000	\$ 67,000,000	\$197,000,000	
Income tax on corporations plus excess profits tax.....	77,000,000	97,000,000	250,000,000	
Customs import duties plus war exchange tax.....	78,000,000	135,000,000	222,000,000	
Sales tax.....	118,000,000	156,000,000	200,000,000	
Excise taxes.....	86,000,000	105,000,000	164,000,000	
All other revenue.....	66,000,000	70,000,000	84,000,000	
Total revenue (as above).	\$481,000,000	\$630,000,000	\$1,117,000,000	\$1,500,000,000
New security issues sold to the public:				
Bonds.....	\$175,000,000	\$253,000,000	\$1,165,000,000	
War savings certificates and stamps (net).....	.....	17,000,000	68,000,000	
New security issues sold to banks.....	20,000,000	200,000,000	250,000,000	
Maturing issues.....	127,000,000	118,000,000	237,000,000	
Net borrowing (as above)	\$68,000,000	\$352,000,000	\$1,246,000,000	
Self-financing by Foreign Exchange Control Board re sterling accumulation.....	.....	19,000,000	211,000,000	
Residual item (reflecting mainly increase or decrease in the government's cash balance).	11,000,000	15,000,000	361,000,000	
Total (as above).....	\$560,000,000	\$986,000,000	\$2,213,000,000	\$2,820,000,000

Source: Bank of Canada *Statistical Summary*, August-September, 1941.

income. In the fiscal year 1941-42, notwithstanding the fact that the national income is expected to be one and a half times what it was in 1938-39, war expenditure is likely to account for about 23 per cent of it.

In the first full year of the war, the Dominion met 64 per cent of its total expenditures (war, nonwar, and aid to Britain) from taxation. Of the loan requirements about four-sevenths were obtained from the banks and the rest from the public.

In the second war year, expenditure rose so enormously that, although taxation was greatly increased, it was able to cover only 50 per cent of the Dominion's total outlays; but the proportion of the borrowing requirements secured from the banks, and not from the public, fell to one-fifth.

For the fiscal year 1941-42 taxation is estimated to yield about 53 per cent of total Dominion expenditure. Approximately 68 per cent of the needed borrowing will be for the purpose of financing Britain's Canadian dollar deficit.

Only a broad outline of wartime tax developments is possible here. The Dominion's tax system consists of two major classes of taxes: (1) taxes on personal and corporate income; and (2) consumption taxes, comprising a so-called manufacturers' sales tax, customs duties, and a variety of excise taxes. The proportion of Dominion revenue derived from taxes on income and profits increased from 27 per cent in the last prewar year to 40 per cent in the second war year. In the current fiscal year the proportion will probably be nearly 50 per cent.

Sales Tax

Of the consumption taxes, the sales tax has been left unchanged at 8 per cent, but exemption has been withdrawn from a number of articles. In some instances, the with-

drawal of an exemption may result in a substantial addition to revenue; thus, as a consequence of the removal of building materials from the exempt list at the end of April, 1941, the government expects to collect in sales taxes on that item during the fiscal year 1941-42 as much as 13.5 million dollars.

Customs Duties

Apart from a considerable increase on tea and coffee (effected by the first war budget), the principal addition to customs duties since the war took the form of the institution (in June, 1940) of a war exchange tax of 10 per cent on the value for duty purposes of all imports, free and dutiable, from non-Empire countries. Though primarily designed to conserve American dollar exchange, the expectation that it would yield considerable revenue has been realized.

Excise Taxes

Each of the war budgets has provided for new or higher excise taxes. The first budget raised the taxes on tobacco, alcoholic liquors, and soft drinks. The second budget sought additional revenue from the taxation of smokers' supplies, automobile tires and tubes, radios and radio tubes, and cameras and photographs. Furthermore, in order to provide another means of conserving American dollar exchange, the introduction of the war exchange tax was coupled with the adoption of a heavy excise tax on new passenger automobiles, steeply graded so as to be virtually prohibitive of the purchase of higher priced cars, which for the most part are either imported from the United States or manufactured in Canada from parts obtained

largely in the United States. The third budget brought within the excise tax net all transportation fares, the receipts of motion picture houses and bets at horse racing meets, playing cards, cosmetics and toilet preparations, and long distance telephone calls. In addition, the budget raised again the taxes on automobiles, wines and beers, and soft drinks. Under this budget, the Dominion government also entered the field of gasoline taxation which had hitherto been occupied exclusively by the provinces. The Dominion tax was set at three cents a gallon.

Corporation Taxes

We turn now to the consideration of corporation taxes. The first budget raised the tax on corporate income from 15 to 18 per cent (from 17 to 20 per cent for consolidated returns). It provided, as well, for an excess profits tax, but the levy was subsequently found to be unsatisfactory in a number of respects and, before any revenue had been collected from it, the second budget substituted a new excess profits tax.

This tax subjected all businesses (incorporated or not) with profits in excess of \$5,000 to a levy of 75 per cent on the excess profits over the average profits of the years 1936-39, inclusive. It was provided, however, that the tax should take a minimum of 12 per cent of the total profits, whether or not such profits exceeded prewar profits. The excess profits tax was superimposed on the 18 per cent ordinary corporate income tax, so that the minimum tax on corporate income actually became 30 per cent. Under the third war budget, the minimum excess profits tax was raised to 22 per cent of the total profits, thus making the minimum corporate income tax 40 per cent.

Income Tax

The personal income tax has also been greatly increased, with the result, as the preceding table shows, that its yield has increased by nearly the same amount as have the receipts from corporate income and excess profits taxes.

The first budget made no change in the rate schedule but required taxpayers to pay 20 per cent more than the nominal amount of their tax. The next budget reduced the personal exemption from \$1,000 for single persons and \$2,000 for married persons to \$750 and \$1,500 respectively, and revised rates sharply upward throughout the whole range of taxable incomes.

To the ordinary income tax was added, at the same time, a flat rate income tax, designated as a national defense tax, to be paid by all single persons with an income of over \$600, and by all married persons in receipt of an income exceeding \$1,200. The tax was set at 2 per cent for the latter, and at 2 or 3 per cent for the former, according as the income was below or over \$1,200. Certain deductions were allowed from the tax for dependent children. As far as administratively practicable, this tax was to be collected at the source by deductions from wages, dividends, and interest.

The third war budget raised the national defense tax from 2 per cent to 5 per cent and from 3 per cent to 7 per cent (the exemption for single persons being increased from \$600 to \$660). The personal income tax was also sharply increased, especially in the lower and middle brackets. The combined personal income and national defense tax, payable at selected levels of income, is shown in Table 2.

TABLE 2

DOMINION PERSONAL INCOME TAX, INCLUDING NATIONAL DEFENSE TAX

Income	Single Persons	Married Persons with 2 Dependents
\$ 1,500	\$ 217	\$ 35
2,500	475	115
5,000	1,332	735
10,000	3,600	2,710
15,000	6,277	5,209
100,000	64,347	61,299
500,000	411,720	400,408

Source: Budget Speech, April 29, 1941.

CENTRALIZATION OF TAXES ON PERSONAL AND CORPORATE INCOME

By augmenting so considerably its taxes on corporate and personal income, the Dominion has greatly increased the equity as well as the productivity of its tax structure. These levies are the most powerful instruments of war finance, and in order to be able to employ them to the best possible advantage the Dominion is anxious to have the exclusive use of them. To make this possible, they must be withdrawn from provincial tax armories. As an inducement to the provinces to cease levying taxes on corporations and personal incomes, the Dominion has accordingly offered to each province which will agree to do so:

1. An annual grant either equal to the amount the province obtained from these sources in 1940 or equal to the amount the province paid out as net debt service in 1940, minus the sum it derived from succession duties;
2. Supplementary subsidies based on fiscal need, should they prove necessary;
3. A grant equal to the amount by which the province's gasoline tax revenue (as a result of the Dominion's entry into the gasoline

tax field) might fall below the 1940 level, provided the province made no change in its gasoline tax rate.

In announcing this offer (in the budget speech of April 29, 1941), the Minister of Finance emphasized that it did not constitute an attempt to get the provinces out of the corporation tax and personal income tax fields permanently. Each province accepting the offer would have the right to withdraw from the scheme at the end of any year, while a year after the termination of the war, the Dominion would discontinue the arrangement, cease making the projected payments to the provinces, and reduce its taxes in the two fields proportionately. From a statement made by the Minister in the House of Commons on November 6, 1941, it appears that the acceptance by all the provinces of the Dominion government's proposal will very soon be secured.

Centralization in the Dominion's hands of these two major tax fields would effect a notable simplification of Canada's tax structure, particularly with respect to the taxation of corporations, for the provinces would cease to impose not merely taxes on corporate income but the whole heterogeneous mass of multi-based corporation levies which have so greatly complicated provincial tax systems. Such centralization, it may be noted, was recommended in May, 1940, after an exhaustive investigation extending over two and a half years, by the Royal Commission on Dominion-Provincial Relations, as part of a comprehensive plan for fiscal and financial readjustment in Canada. But the determined opposition of certain provinces to the Commission's plan, culminating in the abrupt breaking up of a Dominion-Provincial conference brought together in January, 1941, to discuss it, precluded the plan from being put into effect. Nevertheless, with the intensification of the

war effort, the growing subordination of sectional interests to considerations of national welfare, and the great increase in the weight of Dominion corporation and personal income taxes, provincial opposition to the centralization of the levies, at least for the duration of the war, has apparently been overcome.

The Royal Commission's plan, it may be added, called for the complete withdrawal of the provinces from the succession duty field, which they alone occupied, and its surrender to the Dominion. Although, under the budget of April, 1941, the Dominion entered the field, with the intention of remaining in it permanently, it did not include succession duties in the centralization proposals which it placed before the provinces at the same time.

Behind taxes and loans lie Canada's real war effort—the development and use of fighting forces, and the production of the implements of war. It is certain that no considerations of finance will be allowed to stand in the way of the steady expansion of this effort until victory for the Allies is attained.



EDITOR'S NOTE

An address on "War Finance in Germany," was given by Dr. Otto Jeidels, Lazard Freres and Company. Since, however, Dr. Jeidels spoke largely extemporaneously and there was no stenographic record of the proceedings, we are unfortunately unable to publish his address. We regret this omission.

PART SIX

TARIFFS AND INTERNATIONAL
RELATIONS

CHAPTER XVII

ROLE OF TARIFFS IN INTERNATIONAL FRICTION

BENJAMIN B. WALLACE

United States Tariff Commission

THE ERECTION of trade barriers injures producers and merchants in other countries. This produces international friction. This is a fact not open to question. The problem is to define the nature, amount, and effects of that friction. In this discussion, we may perhaps limit ourselves to the attempt to define how far tariffs and other trade barriers can be found to be direct or indirect causes of wars.

ECONOMIC DETERMINISM

To begin with, we may note that this question is one sector of a larger question, that of the relative importance of all economic motives as compared with noneconomic motives. One school of thought believes in economic determinism, that man is motivated primarily by economic need and greed. This school naturally assumes that all wars have economic causes. The task they set themselves is merely to allocate responsibility for war among such factors as competition for markets, for investment opportunities, for sources of raw materials, and so on. After many years in the fields of history, politics, and economics, and much attention to raw materials and colonies, I remain unconvinced of the theory that man is dominated by economic motives.

These economic interpreters of history have many exhibits which they claim demonstrate their thesis. They find that various wars, or diplomatic conflicts short of war, were caused by governments supporting capitalists in their foreign ventures, for example, concessionary companies exploiting or seeking to exploit backward territory. But Dr. Eugene Staley has shown that, in several cases, these concessionary companies were interested in the foreign territory because their governments had egged them on for political reasons.¹

The political reasons have at times included desire to annex more territory and I shall, of course, be told that that is an economic motive. Certainly, economic motives have played a part in acquisitions of territory, but so have the ambitions of statesmen, the desire for national prestige, the desire for power and domination. Incompetence in handling border relations has led to many annexations. To support the conquest of Ethiopia and make it popular in Italy, Mussolini's propaganda played up not only the hostility of the Ethiopians and their alleged misrule, but the vast economic wealth which Italy would acquire. This economic mirage was so obviously disconnected from the known resources of Ethiopia, the prospective profits were so obviously below the costs of conquest, that it is hard to believe the Italian government was really so misled. The true motive was almost certainly the desire to "restore the Roman Empire," to establish Mussolini's place in history among the great empire builders, and to give the Italian army experience in warfare in preparation for the crisis in Italy's fate which Mussolini predicted for the later thirties.

¹ Eugene Staley, *War and the Foreign Investor*.

Again Dr. Staley has, I believe, clearly shown that it is not the desire for access to raw materials that has created wars, but rather wars and fear of wars that have created the desire for political control of supplies of raw materials.² Similarly, so far as I can see, in recent years the desire to wage war and the fear of involvement in war have been more active in creating trade barriers than trade barriers have been in creating wars.

BASIC CAUSE OF RECENT WARS

Trade barriers contribute nothing to peace. They create international ill will. They accentuate nationalism, and nationalism is a prime cause of wars. But trade barriers seem to fall short of being important or direct causes of war, or of being determining factors in the line-up of the powers. The basic cause of recent wars has been the determination of several governments to dominate sufficient population and territory to preclude the possibility that the development of the United States, the British Empire, the Soviet Union, and China would reduce them to the role of secondary powers. There has at no time been any chance of satisfying them with markets or raw materials, or any kind of economic concession; their fundamental demand was empire, and lots of it. While these several governments in their foreign and domestic propaganda have stressed insufficiency of living space, of markets, and of raw materials, they have restricted emigration and encouraged more rapid growth of population. Japan's latest program is to lower the average age of marriage by four years so as to increase the average number of children per family from four to five.

² Eugene Staley, *Raw Materials in Peace and War*.

TYPES OF TARIFFS

So much for general introduction. Let us now review certain types of tariffs, the injuries they do, and the resentments they create. Then we may discuss briefly the historical evidence concerning the contribution of tariffs to war. I speak primarily of tariffs because they are obviously within the jurisdiction of the Tax Institute; because until September, 1939, about one-half of the world's international trade moved either without barriers or subject only to tariff barriers; because they have not been superseded by other methods of control which have been super-imposed upon tariffs; and because, broadly speaking, their effects are the same as those of other restrictions—either by tariffs or by other types of restriction trade may be nearly smothered or only slightly curtailed.

Many have assumed that *revenue tariffs* are of no importance as trade barriers. A duty for revenue only may be defined as one levied upon a commodity not produced nor producible within the country imposing the duty, nor closely competitive with a domestic product; a genuine revenue duty is proposed only by those trying to balance the budget and not by any group of domestic producers. It is thoughtlessly said that the finance minister will not raise the rates of revenue duties so high as to depress trade. He, however, is interested primarily in revenue. He is not likely to maintain rates which yield less than lower rates would yield. Revenue duties are imposed chiefly on articles for which the demand is relatively inelastic, and the rates may be increased by degrees to very high points without cutting deeply into trade. The British tax on tobacco

was progressively raised to some 900 per cent ad valorem,³ while consumption rose steadily. But not all products are so resistant to taxation and so resilient in demand; and my point here is that even if these tax increases had cut off three quarters of the demand, the 900 per cent tax would have produced double the revenue derivable from a 100 per cent tax, i.e., the Minister of Finance would have increased his revenue by reducing trade to one quarter of the former quantity.

The producers of wines and liquors, and of tea and coffee, have at times had reason to feel that revenue duties were serious obstacles at least to increases in consumption, if not to habitual sales. In several countries, notably Italy and the United Kingdom, the consumption of coffee has been diminished by heavy revenue duties or more drastic restrictions on trade. American sales of gasoline and oils in Europe were severely curtailed by taxes of 15 to 75 cents per gallon in various countries.

European producers of wine resented the prohibition law in the United States, more effective than any revenue duty; but I do not see that their resentment had any political consequences.

Export duties have so far caused little resentment for the rather obvious reasons that they have been less numerous and very much lower than import duties. The United States has no export duties and leading European States have had few or none. Export duties for revenue commonly run from one to about five per cent ad valorem, and do not cause friction; though some commercial treaties have had specific stipulations against export duties. In a few cases, however, high export duties or restrictions have

³ Assuming for tobacco an average value of a shilling per pound. Since the war began, the rate has been raised to some 1900 per cent. Imports have been severely restricted by the exchange control.

been used in connection with monopolies or quasi-monopolies, tending to convert control of a raw material into control of a finishing process, or with the object of exploiting the foreigner by increasing the price. In more recent years, such attempts have tended to take the form rather of production-and-price controls. Potash and nitrates, and more recently, tin and rubber are conspicuous examples of products which have caused great international friction through measures connected with, or enforced through, export duties or export controls.

Discriminatory tariffs have a peculiar capacity for arousing resentment because of the special feeling of injustice that accompanies them. The colossal British duty on tobacco has been resented not half so much because it amounted to 900 per cent ad valorem, as because some 200 per cent of the value of the tobacco was remitted as a discrimination in favor of Rhodesian and other colonial tobaccos. For products which are more uniform than tobacco, or more precisely graded, the resentment against differential duties arises from the effectiveness of slight differentials in shifting the origin of the supply from one country to another. The pledge of most-favored-nation treatment is essentially a pledge of equality of treatment, and its dominance of commercial treaties has developed from the insistence of every power that it be not discriminated against.

Their often discriminatory nature has given undue prominence to colonial tariffs, that is, prominence out of proportion to their economic importance; and the system of British Imperial preferences in tariffs has caused much resentment among producers in the United States and has been the cause of much concern on the part of the American government.

Protective or bounty tariffs are the core of our subject, and their results are complicated and difficult to evaluate. Various as they are, we may make one sweeping generalization. Tariffs, or other devices to diminish or exclude competitive imports, are now almost universal, and they represent determined policies not likely to be changed radically in the foreseeable future. As fixed policies, they are normally not subject to very drastic changes. Either by more or less continuous piecemeal executive action, or by periodic legislative revisions, these barriers have been gradually moving upward for the last sixty years. Normally, the changes in any year, or even decade, are not very extensive. It seems improbable that we shall ever see other such jolts given to world commerce as those given by the sudden flop of Britain into protectionism in 1932 (on top of devaluation of the currency), and by the adoption by Germany and Italy of war economies.

TRADE AGREEMENTS AND GOOD WILL

Further, the European tariff system of the last half century included considerable padding of tariff rates. Roughly once a decade, new rates were published—rates higher than it was really intended to enforce; and then in a series of commercial agreements, commonly made before the revised rates were put into effect, somewhat lower rates were conceded by agreements with the other countries which also pursued bargaining tariff policies. Although generally the tariff bargains only brought the rates back to points already determined by the tariff-making authorities, the system did allow, in part, some additional concessions in regard to commodities which created the most friction. After the tariff bargains, however, the rates were normally higher than they had been before the revision of the tariff.

Whatever we may conclude concerning the friction created by tariffs, the making of trade agreements of the American type—genuine reductions from a tariff not padded for bargaining purposes—undoubtedly creates good will. The net result may be an important amount of international good will, though some of the negotiators may lose their good will during the course of the negotiations. The negotiators may also lose the good will of various groups of voters in their respective countries.

TARIFF INJURIES

Turning to the effects of tariffs, we note first that "an old tax is no tax." At any given moment, the height of import duties may be considered almost immaterial in international relations in comparison with the breadth of the comparatively recent increases in rates. Usually, it takes only perhaps two to five years for the trade to adjust itself to the effects of normal, small increases in tariffs, and in that time the change in tariff rates has exhausted its effect as a cause of international friction, in so far as the friction rests directly on injury to trade. Every general tariff revision, however, is likely to contain one or several drastic increases which strike severe blows against the producers of particular products. A conspicuous illustration of an abnormally abrupt and damaging tariff increase was that on tin plate enforced by the United States in 1891, which injured the British tin-plate industry so severely that it was a dozen years before it recovered its previous output. Other examples might be cited, but that these are not typical changes is shown by the steady development of international trade throughout the protectionist period, at least through 1929.

Certain other exceptions may be noted, however, to the

rule that tariff effects are produced immediately and are shortlived. Tariffs appear at times to be without substantial effect at the time of imposition, but when conditions change, they serve to build up a domestic industry and eliminate competing imports. The high general tariffs found, for example, in several major countries of Latin America have produced such effects. They were imposed (generally at lower levels) on hundreds of products not then produced in the respective countries, but they have grown high enough to be a constant invitation to capitalists to establish industries within their shelter; and for several decades such duties have been the immediate stimulus to the establishment of processions of small industries in Latin American countries.

The injury to foreign countries caused by increases of tariff rates (or other trade barriers) depends on many factors of which, perhaps, the chief are the amount of the tariff increase, the elasticity of demand for the product, the potential capacity of the country which erects the trade barrier to initiate or expand the production of the product, and the degree of the dependence of the exporting industry on the markets, or market, in which tariff increases have taken place. The United States import duty of 1891 was such a tremendous blow to the British tin-plate industry because it combined three most injurious factors. The tariff rate jumped from about 30 to about 70 per cent *ad valorem*; the American steel industry had already made great progress and was just ripe for the rapid development of large-scale tin-plate production; and more than half of the British output had been sent to this market. Consequently, the blow to the foreign industry was of most unusual severity.

It is hard for Americans to realize to what extent the

European countries, particularly the smaller countries, have been dependent on exports. In the middle twenties, for example, it was reported that 90 per cent of Belgium's glass was exported, and a similar percentage of Swiss watches. If a leading industry so dependent on exports loses its chief markets, or finds them drastically curtailed, it is a cause of grave concern not merely to the one industry, but to the whole country whose prosperity is in considerable degree bound up with the prosperity of its leading industries. The extent of international friction produced by trade barriers is, therefore, much more obvious to Europeans than to Americans.

Another important point is that under a free economy farmers and producers of certain dutiable raw materials have suffered more than manufacturers from the Great Depression. Because of the difficulty of adjusting agricultural production, and because of the inelasticity of demand for agricultural products, trade barriers not only cut off sales in foreign markets, but drastically depressed prices in the countries of origin. For example, in the late twenties and early thirties, European countries importing wheat, by drastic tariff increases and other measures, reduced the importation of wheat by 400 million bushels per year; and this decrease rapidly piled up an enormous surplus in the exporting countries. The price of wheat was driven down to disastrously low levels. Similarly, the countries dependent on the export of sugar were prostrated by the restrictions continually applied and increased by importing countries in the twenties and early thirties. So, also, were many other agricultural products, and some raw materials.

On the other hand, we may note that certain countries, noticeably in Latin America, are fortunate enough to export mainly raw materials of types not usually dutiable in

the industrial countries, or tropical foodstuffs which have so far escaped duties at least in the United States, the major market for Brazilian coffee, Central American bananas, and numerous other products.

MORE OR LESS FRICTION

A study of the amount of direct economic injury caused by tariffs is only a first approach to the evaluation of international frictions. Obviously, the friction is not necessarily proportionate to the injury, but may be either greater or less. If the tariff has been raised by a country which is already disliked, and if the producers adversely affected have ready means of publicity and great influence, the friction created in the injured country may be magnified accordingly. The resentment may be greatest at the time of passage of a new tariff act and then is likely to be proportioned to the fear of injury, commonly greatly exceeding the injury itself. In a country sensitive to its foreign interests and its dependence on foreign trade, obviously the public will be much more quickly and seriously aroused by the threat than would the people of the United States. They may demand retaliation or boycotts. There is also the likelihood that if widespread tariff increases are imposed before the onset of a cyclical depression, or in its early stages, these tariff increases will be more widely credited with being the immediate and chief cause of the depression in trade than would be supported by careful analysts.

On the other hand, for various reasons, the amount of friction created may be comparatively slight. The populace in the injured country, if they are not much interested in foreign trade, may remain in comparative ignorance of the effects of the foreign tariff increases, and they may harbor comparatively little resentment. Again, they may

feel the depressing effects, but blame them on errors of domestic policy by an unpopular government. They may have been so indoctrinated with the idea that the tariff is a domestic issue, and arbitrary changes in tariff rates a sovereign right, that they feel the inconsistency of taking issue with any foreign country for its actions in the field of commerce. They may be convinced (as many Americans appear to be convinced, perhaps without sufficient study of increases in the trade barriers of other countries) that their own country has one of the world's highest tariffs and that they are estopped from criticizing other countries for trade barriers. Or they may be Englishmen who have been shown by Sir Arthur Salter that their own abrupt tariff increases of 1932 constituted the greatest blow of that period against the world's commerce. They may have been softened by propaganda; for example, they might believe that the North American wheat surplus was the sad result of overexpansion during the World War rather than the result of the restrictive European policies of ten to fifteen years later.

In any case, the resentment caused by tariff increases tends to die out as the effects of those increases begin to wear off. Besides the readjustment in individual industries, general tariff increases tend to readjust international price levels, and the readjustment is in the direction of nullifying the effects of the tariffs. As already noted, the typical tariff increase in this country and many others is a comparatively mild one. Abrupt increases may certainly be cited, such as raising the duty on toys in 1922 from 35 to 70 per cent ad valorem, but the typical increase is rather in the nature of a slight readjustment of duty by the addition of, say, 5 or 10 per cent ad valorem to the existing rate.

On the other hand once more, the processes of readjusting international price levels is not painless. If the trade barriers of a large country cut off important sales, it tends to depress the currencies of other countries, to diminish their purchasing power, to bring about a new equilibrium at a lower level of trade all around. It makes it more difficult to pay debts to the country which has raised its trade barriers, and while after several years the readjustment is presumably complete, and current economic stresses are no longer rightly attributable to that increase in the trade barriers, nonetheless a sense of soreness remains in the foreign countries. There is a tendency to blame any current ills, for example, lowered standards of living, upon the country with the high trade barriers. Until the trade barriers are removed, perhaps beyond that, the large country which has attained a reputation for extreme trade barriers is likely to be considered a prime cause of the world's economic ills.

We may conclude that there is no close correlation between the extent of the injury caused by trade barriers, and the amount of international friction generated. But is the correlation any closer between the friction created and the possible explosion into war?

FRICTION SHORT OF WAR

In approaching an answer to this question, we begin by repeating that tariffs and other trade barriers work real injury to foreign countries and necessarily create ill will. This ill will must be acknowledged as a predisposing source of war. But it is very difficult to measure or define the extent to which this predisposition turns the scale in favor of war. Certainly, it has not been the direct and immediate cause of wars. Governments do not declare war be-

cause a foreign government raised its tariff, nor do they issue ultimatums demanding that trade restrictions be rescinded within forty-eight hours. Seldom have governments even made formal protest against tariff increases, though informal "representations" are considered not out of place.

War is obviously too crude and costly a device to be used, or even threatened, for economic injuries which are supportable.

If other factors are at all comparable, the smaller the country the more likely it is to be highly dependent on foreign trade, and the more certain it is to have suffered from restrictions on foreign trade. But if a small country is particularly dependent upon any one market, that market is certain to be found in a major country against which the smaller could not possibly go to war. The small country, on the other hand, cannot seriously injure the economy of the major country, and in its own interest would probably avoid the attempt.

Among the major powers, Britain and Germany formerly exported about one-fourth of their total domestic production, chiefly manufactures, and thus were vulnerable to injury by foreign trade barriers. But no one market took more than a fraction of total exports and when all were restricting trade, how could that be a cause of war against anyone?

EUROPEAN WARS

If tariffs had caused wars, we might expect to find many wars in Europe, among the countries highly dependent on neighboring markets. If a sudden increase of trade barriers provokes a hostile and concrete reaction in another country, history tells us it will cause a tariff war rather

than a military conflict. As the countries of Europe, by successive installments, raised their tariff rates after the free-trade period of the last century, there were quite a number of tariff wars, some of them serious and protracted, such as that between France and Italy. These did not grow into shooting wars. In fact, the whole period from 1815 to 1914 was almost devoid of wars in northern and western Europe. Norway, Sweden, Holland, Belgium, Spain, and Portugal had no wars in Europe. The only European war waged by Great Britain was the Crimean War, to prevent the expansion of Russia in the middle fifties. Between the revolutions of 1848 and 1870 Prussia under Bismarck, France under the Emperor Napoleon III, and Italy under Cavour engaged in three wars apiece, variously motivated by desire for conquest and for national unity. But all of these wars took place in the free-trade period. The wars in the Balkan States were likewise wars of nationalism primarily.

Protectionism revived in the late 1870's, and from the same period is dated the scramble to annex territories in Africa and Oceanica. The protectionism was certainly one cause of the scramble; but the sharpness of the competition for additional territories was somewhat mitigated by Britain's devotion to free trade, and by numerous British, German, Belgian, and even French open-door pledges for the new colonies. In this period of rising tariffs, of tariff wars, and of colonial rivalry, no armed conflict broke out among the Western European Powers until 1914; though Russia and Turkey fought in 1878, and there were several Balkan wars.⁴

⁴ War was perhaps closest over the Fochoda clash, the Dogger Bank incident, and the Moroccan crises. Tariffs were not in question in any of them.

When the World War broke out in 1914, the colonial boundaries had been fixed for one or two decades, the tariff wars had all been settled, the United Kingdom was still on a free-trade basis, the United States had just lowered its rates from the levels established in 1897 and maintained in 1909. France had made a moderate upward revision in 1910, but the German tariff, among others, had been stable and largely stabilized since 1906. There was talk about the commercial rivalry between Germany and Britain, and some extravagant statements were made, based on misleading percentages, about Germans supplanting Britons in the trade of India and elsewhere. In fact, both British and German exports were steadily expanding.

It is true, on the other hand, that part of the bad feeling between Austria-Hungary and Serbia was caused by the restrictions, chiefly "sanitary," which the former had enforced against the exports of Serbia—the so-called "pig war." That war, however, had ceased on January 1, 1911, three and one-half years before the Austrians and Germans seized upon the murder of the Archduke as the occasion for extending their power in the Balkans.

Incidentally, it may be noted that Serbia represented an extreme degree of dependence on a single market. Earlier Austrian policy had fostered the economic dependence of Serbia, and in the years immediately before the trade war started, 86 per cent of Serbia's total exports went to Austria. In two of the years of the intermittent trade war, this percentage was cut to 16 per cent and 19 per cent. Serbia, however, found sufficient markets to maintain the total value of her exports! In any case, she had an agricultural economy largely self-sufficient, with exports of only about \$6.00 per capita. The trade war caused no political difficulties in Austria-Hungary, where the

farmers were clamoring for exclusion of agricultural imports, and where exports to Serbia were only 3 per cent of the national total. In fact, Serbia's measures in the trade war had been directed primarily at the transit trade to Austria. The so-called termination of the trade war did not allow a recovery of previous Serbian exports to Austria, which in 1912 represented only one-half of the earlier huge percentage.⁵

Some have thought that this tariff war (following some earlier tariff disputes) was a main cause of the hostility between Serbia and Austria before 1914; others with much greater reason have stressed the growing feeling of nationalism in Serbia, the discontent of the Serbs held under Austrian rule and the determination of those two bodies of Serbs to unite, and, particularly, the hostility created by Austrian occupation of Bosnia and Herzegovina in 1878 and their annexation which led to Serbian mobilization in 1909. Further, it is pointed out that Austria's trade and tariff policy toward Serbia was itself dictated by political objectives. In any case, it is hard to believe that the Austro-Serb trade war caused the German government to give Austria the famous blank check which started the World War.

In the period preceding the second World War, there have been multitudinous and even discriminatory trade restrictions, but only a limited number of tariff wars have risen from them. They have caused immense injury to trade, and widespread resentment; but the theory that popular resentment or hatred means war will not bear analysis. Centuries ago it was a proverb that a King did not start a war without figuring out his capacity to meet the forces

⁵ Walter Bennett Harvey, *Tariffs and International Relations in Europe, 1860-1914*, Chap. VI.

which another King might bring against him. Today more than ever, before states engage in tariff wars or military wars, they take account of their whole position, and explore with caution, rather than rashness, the possibility that they may suffer great losses without accomplishing the removal of the objectionable restrictions. Even in the democracies, popular feeling does not make wars. Popular feeling may be favorable to war, but only in Yugoslavia has it overthrown a government in order to make war. Elsewhere war—or perhaps surrender—has been decided by the government on the advice of generals, admirals, and of diplomats who are cautious, if not timid.

RECENT TARIFF WARS

The tariff and other trade restrictions of the last twenty years have produced numerous tariff wars, but few of great consequence. Seven years of tariff war between Germany and Poland did not prevent the nonaggression pact of 1934, nor prevent Hitler from sticking to it for five whole years. Six years of tariff war between England and Ireland probably did not perceptibly increase the dislike of the Irish for the English. The tariff war between Hungary and Czechoslovakia has been thought to have exerted some influence in inclining Hungary toward the Axis camp;⁶ but territorial demands were assuredly the dominant consideration in Hungary's line-up. The short trade wars of Japan against India, Australia, and Canada have not improved the standing of Japan in the British Empire, but they can scarcely be considered important factors in the general policy of British defense against Japanese aggressions in Asia. Similarly, the withdrawal of most-favored-nation treatment by the United States from Germany, and

⁶ Harold S. Diamond, *Experiment in Tariff Making: Czechoslovakia*.

temporarily from Australia, can scarcely be regarded as significant. The Germans perhaps took the initiative in the denunciation of the most-favored-nation pledge of 1925; and the penalizing of German products was the result of applying our law in relation to discriminatory German commercial and monetary policies. Assuredly, present American policy toward Hitler is not caused by German trade policies, though fear of the extension of those policies is a part of the fear of the consequences of allowing Hitler to conquer vast territories.

PROPAGANDA

One of the most successful propagandas that the world has seen has been that of the Germans against the Treaty of Versailles. They have represented the "have not" countries as being driven to desperation by the oppressive policies of the other countries denying markets to the products of Germany, Italy, and Japan, and denying them "access to raw materials." This propaganda was swallowed by numerous uncritical liberals in this country. The theory was set forth, for example, by Frank Simonds in his volume entitled *The Price of Peace*. He failed, however, to take the precaution of checking the assumptions on which his book was based. Had he done so, he would have found that the miscalled "have not" countries were suffering less from trade barriers and the depression than were the countries which were being accused; that to a considerable extent the "have not" countries threw the burden of the depression on the "haves"; that when complaining loudest about access to raw materials, they were in effect being subsidized by sales from the miscalled "have" countries at prices below cost of production.⁷

⁷ Benjamin B. Wallace, *Fallacies of Economic Nationalism*. See also James T. Shotwell, *What Germany Forgot*.

ECONOMIC PRESSURE

Of course, Germany suffered from trade barriers along with other countries. If other countries had raised no trade barriers, it would have been easier for Germany to have built up her armament, and possibly the German people would not have been deprived of so much butter in order that guns might be made. But it should be remembered that: (1) from 1925, Germany contributed in important degree to the world's trade barriers, especially to the agricultural barriers, which were an important factor in bringing on the great depression;⁸ (2) Germany showed no unusual zeal in trying to get trade barriers removed if that removal had to include her own; (3) Hitler's trade policy was dominated by political and military considerations throughout; (4) foreign trade barriers were the theme of only a minor part of the domestic war propaganda, which covered the Treaty of Versailles, reparations, territorial demands, war guilt, colonies, access to raw materials, and the Jews.

Of course, some will say trade barriers do not cause wars directly, but they produce economic conditions from which wars naturally spring. This way of stating it likewise seems to me misleading. Judged by production and trade indexes, the United States suffered more from the depression than Germany, Britain more than Italy, and France more than Japan. Britain, in fact, has been depressed since the end of the last war trying to readjust after progressive losses of foreign trade; but the economic pressure in Britain stimulated the isolationists, pacifists, and appeasers, not the warmakers. France, Belgium, Switzerland, Czechoslovakia were all seriously affected by trade barriers, but

⁸ League of Nations, *World Economic Survey, 1931-1932*, pp. 279-80.

it did not make them belligerent. Relatively, the United States suffered most of all from the depression. We suffered vastly more than Germany can be imagined to have suffered economically from the Treaty of Versailles. But if this economic pressure had any effect on our foreign policy, it was to cause the withdrawal of the marines from Nicaragua, Haiti, and Santo Domingo, the abandonment of the treaty right to intervene in Cuba, and the making with Cuba of the most favorable trade agreement that one country ever gave to another.

Economic pressure is alleged to lead naturally to war, but it has had no warlike effects in countries whose peoples and whose governments have rejected the idea of conquest, and have sincerely rejected war as an instrument of national policy. No, the decisive element is not the economic, but the political—the people's traditional predisposition in favor of war, the military attitude of the nation's leaders, the rulers' desire for conquest.

JAPAN AND MANCHURIA

It is true that Japan seized Manchuria in 1931 shortly after passing the lowest point of her depression; but it is also true that Japan had a small recession rather than a depression. Whereas steel production in the United States fell off by 75 per cent and for five years averaged below 50 per cent of previous output, Japanese steel production fell off by less than 20 per cent for one year. Only for one year did the profits of Japanese textile mills fall below 12 per cent. The choice of time for the attack on Manchuria was probably decided not so much by the business recession in Japan as by the situation in the other countries, which should have imposed economic sanctions on

the aggressor but found it more difficult to do so because they were in the depths of depression.

In 1939 Lionel Robbins lectured on the economic causes of war, making this comment on Japan:

. . . Whatever we may think of the justice of the Japanese attack on China, there can be no doubt of its connection with the restriction of the Japanese market. In 1929, with the advent of the Great Depression, the market for Japanese silk in the United States and elsewhere collapsed. Now silk was the chief item of Japanese export. The collapse was a major catastrophe. It was only to be expected, therefore, that the Japanese would turn as rapidly as possible to other forms of export. This they did; and immediately the markets elsewhere were effectively closed against them. In Ceylon, for instance, in one year the import of a certain kind of Japanese cloth was reduced to one-tenth of its former dimensions. The connection between such events and the invasion of China is so obvious as to need no elaboration.

I submit that it is such uncritical and exaggerated repetition of propaganda that is responsible for the current overemphasis on trade barriers as a cause of war.

The price of silk certainly collapsed in 1929, and even the quantity sold declined. But even including manufactures of silk, this was due in only a slight degree to tariffs. The decline in the price of raw silk—with raw silk constituting 36.5 per cent of Japan's total exports in 1929—was certainly a major catastrophe for Japan and it should have made the Japanese more sympathetic with other countries which depended in greater degree than did Japan on the export of raw materials. Japan was fortunate in being an exporter chiefly of manufactures and an importer primarily of raw materials, which it suddenly acquired at bankruptcy prices. For example, in 1931 Japan imported more cotton than in 1929 and paid only about one-half as much for it. Since Japanese exports other than raw silk are produced almost entirely from imported raw materials, most

of the decrease in the value of imports, during the three years during which Japanese exports were depressed, should be deducted from the loss of Japanese exports in order to obtain a true picture. In contrast, the United States exports almost exclusively products produced from its own raw materials; the decline in the value of exports, therefore, represents decreased income either to domestic manufacturers or domestic producers of raw materials, or both. Japan has been unfortunate, however, in that its only important raw material has suffered from the competition of a synthetic substitute, but it may be noted that the decline in price and sales of raw silk must be attributed in part to the rapid development of rayon by the Japanese themselves. Over the longer period, say 1925 to 1940, the decline in the price of silk has been offset in large measure by improvements and economies in production.

Aside from the comment on silk, Mr. Robbins' comment is misleading rather than helpful. The Japanese had been rapidly developing other forms of export *before* the collapse of the price of silk; and the trade figures do not support the statement that "immediately the markets elsewhere were effectively closed against them." In particular, his specific statement on Ceylon successfully conceals from the reader what happened. Ceylon's imports from Japan in 1932 were 25 per cent above those of 1929, and in 1937, 50 per cent above. Meanwhile, the British had lost in 1933 two-thirds by value of their exports to Ceylon, and in 1937 were still almost 40 per cent below the 1929 figure. India was not much better off in the Ceylon market, and Burma was worse off. While Japan in 1937 supplied Ceylon's imports to a value 50 per cent greater than in 1929, the United States supplied less than one-half of the 1929 figures, and Germany little more than one-half.

While quotas applied in 1934 against Japanese cottons and rayons entering British colonies were based on average imports of 1927-31 and thus treated the Japanese very roughly, the impression widely created that the markets of the world have been "effectively closed" to Japanese products is misleading and false. Prior to Japan's renewed attack upon China in 1937, her trade had been not only expanding, but expanding more rapidly than that of almost any other country, so that her share of the world's trade had been increasing. It is true that numerous trade restrictions throughout the depression were aimed primarily at Japanese trade; but in any period, trade barriers are directed primarily against products and countries which are expanding most rapidly. During the last decade most countries have found their exports reduced in quantity and value by foreign trade barriers, and only in the latest years, if at all, have they recovered to the 1929 figures. In quantity, Japan's exports dipped below those of 1929 only in two years, and then not below 1928. In 1937 when the world had barely recovered the total quantities of exports attained in 1928, Japan was exporting more than twice as much. In value, aside from raw silk which as we have seen suffered severely but not from trade barriers, Japan already in 1933 had beaten all previous records for exports, and in 1937 was 50 per cent ahead of 1929; while the United States, the United Kingdom, and Germany were still 30-odd per cent behind their 1929 figures.

The Japanese have indeed complained about rising trade barriers, and more loudly than numerous other countries whose total trade was obviously suffering as total Japanese trade was not. If the net injury to trade is the criterion, it would seem that almost every other country

should have been more incited to war than was Japan by the world's trade barriers.

If the cause of an event be something which turns the scale and without which the event would not have occurred, I see no sufficient reason for saying that trade barriers were the cause of Japan's attacks on China.

Japan began her territorial expansion in 1868. She fought with China in 1894 and took Formosa, and would have taken other territory except for a European combination against her. She fought Russia in 1904 because of Russian encroachments toward Korea, which the Japanese said was a dagger pointed at the heart of Japan. She took Korea, and annexed it in 1910. In 1915, when Japanese feared that Yuan Shih-kai would unite China under a strong government, Japan, in effect, demanded a protectorate over China. In 1913, Walter McLaren found the Japanese people united in support of a policy of external expansion. In that year, the United States tariff was being reduced; China's tariff was limited to five per cent ad valorem, that of the Netherlands East Indies averaged only six per cent, and India and Britain were on a free-trade basis. These were Japan's chief markets; and in 1913 trade barriers did not supply the urge to annex other people's territories.

During the World War, the Japanese seized China's province of Shantung, but after the war, the loss of the alliance with Britain and pressure from other powers forced her to abandon it. So far, none of these aggressions can be attributed to economic pressure arising from declines in foreign trade, for Japanese trade throughout the period was rapidly developing.

Japan was relatively peaceful during the 1920's but continued her intrigues to keep China weak and disunited, and

continued the process of economic penetration, particularly in Manchuria.

It is, of course, a matter of opinion, but the evidence scarcely supports the view that Japan would have kept the peace in the 1930's if the world's trade barriers had been decreasing instead of increasing. The Emperor Hideyoshi, in the sixteenth century, made plans for the conquest of Korea, China, the Philippines, and India. In 1936 or 1937, Professor Reischauer found that 99 per cent of the Japanese people supported the policy of forceful expansion. Apparently, the intervening centuries had produced no change of basic attitude. There have, indeed, been differences of opinion in Japan concerning foreign policy; but the differences have been on such points as: which region to attack first, whether the army or the navy should bear the brunt of the advance, and what excuses should be put before world opinion. Reviewing Japan's whole rise in trade and industry up to 1937, we see that not increasing economic pressure but a rising standard of living has coincided with greater armament and an expanding ambition to conquer all Asia.

AMERICAN WARS

In passing, we may note that recent wars in Latin America have been over disputed boundaries and have been between countries which for geographic and other reasons have had conspicuously small amounts of trade with each other—so little, that trade barriers could scarcely be noticed.

The United States had a war with Mexico, and in recent decades some near-wars, but I do not recall that trade barriers made any significant contribution to the difficulties. The United States had a war with Spain to clinch

the freedom which the Cubans were winning. Danger to American investments and disruption of trade were very minor incitements. The trade barriers of the United States and of Spain, however, may have contributed directly to the Cuban discontent which resulted in revolt.

CONCLUSIONS

I have tried to see both sides of this question, but my conclusions are critical of the views of those who assess trade barriers as of great importance in producing the belligerency of the aggressor countries. The evidence shows that tariffs and other trade barriers have not contributed directly to the outbreak of war, and even their indirect contributions have been of minor significance. Their greatest contribution, in my opinion, to the outbreak of war in Europe has been that German propaganda has used them successfully to blind uncritical liberals to the revolutionary plans and purposes of the Nazi Party, thus seriously confusing and delaying the resistance of the democratic powers, and encouraging Fascist aggression.

It does not follow that trade barriers are unimportant in international relations, either in economics or in politics. In the long run, we may hope that the decades of peace are more important than the years of war, and during these decades trade barriers affect national and international relations in many important ways short of war.

Further, it may well be argued that total war is such a colossal calamity that any element of policy which contributes, even slightly and indirectly, to the catastrophe should be forthwith and unanimously abandoned.

These negative comments on the role of trade barriers in international friction should not be construed as applying to the seventeenth or eighteenth centuries, on the one

hand, nor, on the other hand, to the future. If the Axis Powers win the war and set up great regional economies, he would be rash indeed who would predict the maintenance of peace, or who would predict that the friction created by totalitarian control of trade would make no measurable contribution to the outbreak of war. If the opponents of the Axis win, something in the nature of a stronger League of Nations is already foreshadowed. It is hard to see how such an organization could thrive unless founded on justice and good neighborliness. It must set up new and higher standards for international relations. It must almost necessarily go beyond its predecessor in the regulation of international problems. If it has jurisdiction over abrupt and drastic tariff increases and the erection of other trade barriers, it may prevent them from fomenting international friction; but if a new order is established professing to rest on good neighborliness, and it does not prevent the international dislocations caused by sudden shifts in international trade policies, these injuries will certainly be resented more vociferously than similar injuries in the recent past have been resented, with what results on the success of the League we cannot predict.

The elimination of war is a complex business. No simple formula for action in a single sphere, such for example as the formula of free trade, will suffice to solve the problem. We tried once to end war by a single great victory, let us not again imagine that one act, one formula, one sector of policy will suffice to suppress this hydra-headed monster.

CHAPTER XVIII

POSSIBLE TARIFF POLICIES OF THE FUTURE

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IN TIMES such as these no one, specialist or layman, can look into "the seeds of time" and predict with any confidence which will grow and which will not. We are all aware of the fact that we are in a period of great transition, a time when not merely the superficial aspects, but even many of the fundamentals of our old order are passing away, but we do not, and we cannot, foresee with any great clarity the dim outlines which constitute the "shape of things to come."

One thing, however, is clear, and that is that the clock is never turned back, that the postwar world, whatever it may be, will not be the world of 1939. Likewise, there is the uncomfortable realization that "Time's wingèd chariot" is hard upon our heels, and that unless we do what we can to look ahead, we may be called upon suddenly to make many decisions of transcendent importance even before we have had time to weigh and consider what the proper course of our national policy should be. These things being true, I should like to devote the major portion of my brief paper to a discussion of the circumstances and conditions which will determine, or at least, influence, the nature of postwar commercial policy. Without this, it seems to me that any attempt to discuss postwar tariffs becomes essentially unrealistic and academic, and a person in my

profession is perhaps abnormally sensitive to the criticism which is always implicit when anything is characterized as "academic." Let me hasten to add, also, that what I have to say is predicated upon the assumption of an Axis defeat. Time does not permit the discussion of both possibilities, and of the two, this is the only one which we are prepared at the present time to accept as a basis for our thinking.

POSTWAR TRADING STRUCTURE

The general outlines of our problem are reasonably clear. The relationship of depression-engendered trade barriers to the intensification of political tension—and, ultimately, the outbreak of the present war—is spread clearly upon the pages of contemporary history, and we all realize how futile it is to expend billions of dollars and millions of useful lives unless we can somehow hope to win the peace as we hope to win the war. It is clear that we may lose the peace if, in the postwar period, we are to have a world in which excessive interference with the movement of trade perpetuates a situation in which, under the guise of autarchy, there is artificial stimulation of uneconomic production, resulting in high-cost consumers goods, the while great and naturally efficient productive regions must continue to practice a policy of production limitation. This is a procedure which can only result in the gradual impoverishment of all peoples concerned. Understandable as a policy of *sauf qui peut* in the recent past, it is not and cannot be a sound basis upon which to build a postwar trading structure. Its widespread adoption will so constrict the flow of postwar trade as to make it impossible for countries to finance the repayment of the flow of international capital which will be necessary for relief and reconstruction purposes.

But even though we can all agree in theory that a reasonable freedom of trade is an indispensable basis for world recovery, and for the achievement of that advancement in human welfare which is envisaged by the Atlantic Charter, we are equally conscious of the appalling obstacles which will confront us on that much anticipated day when the last shot has been fired and the last bomb has been dropped. We will have a world in which, for some years, the great bulk of international trading has been carried on between governments rather than between private traders; a world in which the use of special trade control devices, such as exchange control and clearing and commodity agreements, has become almost the standard practice of important trading nations, belligerent or neutral; a world in which old trade channels will have been destroyed and many new ones cut; we will have a world in which many traditional trade barriers will have been erased as a result of the Nazi domination of Europe; and, finally, a world in which victor and vanquished alike will be confronted by commercial and financial problems, the complexity of which will tax the ingenuity of statesmen to the utmost.

In terms of commercial policy, it is important, I think, to make a very sharp distinction between what may be necessary, on the one hand, during this more or less prolonged period of reconstruction and transition back to a peacetime economy, and, on the other hand, what we may hope to have on a rather more permanent basis thereafter.

Although we are right when we conclude that the destruction of the Nazi "order" is an essential precondition to the restoration of a freer world trading system, we must avoid the overly simple conclusion that military victory

will be followed shortly, and almost automatically, by the disappearance of obnoxious trade controls. Consider for a moment the position of Britain after the war. Although, presumably, our lend-lease arrangements will not result in any direct dollar obligations owing to us, the matter of consideration has not yet been settled, and as recently as last week Foreign Secretary Eden's assertion in the House of Commons that, "Under the lease-lend arrangement there is no accounting and no debt piling up" was promptly corrected by the subsequent official statement that, "Britain is of course committed to return everything she receives and everyone knows this is an obligation which must and will be met." Even disregarding all lend-lease obligations, Britain will be desperately short of dollars for some time after the end of the war, and this situation will be intensified intolerably by any attempt to add thereto any *quid* for our *quo*. A substantial portion of British foreign investments will have been liquidated, raw material stocks will be low, and the need for food imports will be great. Under such circumstances, it is unrealistic for us to assume that Britain will not feel obligated, for a time at least, to continue to protect her position by the use of exchange controls and clearing agreements. Even among those British economists who have been traditionally hostile to these trade practices, there is a growing realization that an early return to anything like predepression freedom of trade is probably out of the question.

The prospective position of the European continent is equally unpromising. Here, too, import needs of food and raw materials will be impressive. Forest lands have been denuded and normal agricultural production distorted by the effects of war, industries have been shattered, occupied countries have been stripped of essential industrial ma-

chinery, and whole factories have been uprooted and moved to other parts of the continent. The magnitude of forced sales of private property to Germans has complicated the problems of industrial ownership into a tangle, unprecedented in human history, and one which will require a generation of lawyers and jurists to unravel. Some areas have been flooded systematically with paper currency, and restored postwar governments may have great difficulty in avoiding catastrophic inflation.

In the absence of bold and imaginative measures by Great Britain and the United States, the statesmen of these restored countries will be under compelling pressure to protect industrial revival, and to prepare to service their indispensable capital imports by the establishment of drastic trade controls. Such a statement presupposes, of course, the re-establishment of a great many independent states in Europe, but the Atlantic Charter promises this as a first step to peace. Politically necessary as this may be, it would be tragic if statesmanship were to go no further than this.

If the European countries do maintain these trade controls, then the United States may have little or no alternative but to follow the same course. At the end of the last war, we hastened to increase the tariff wall in order to keep out the anticipated flood of goods coming from countries with depreciated currencies. In so doing, we forged a first link in a tragic chain of events which a decade later was to bind the entire world with the shackles of an unprecedentedly great depression. If we wait until the end of the war to begin to think about our future economic relationship to the remainder of the world, it may not be possible, politically, to prevent the same forces from dominating our councils once more. This time, these forces may be

even more powerful, and if European trade is controlled and constricted, there may be no way by which we could be prevented from following the same course. And, of course, this problem is not merely one of political psychology, for it is doubtful if, with the best of intentions, we could avoid a policy of trade control if it were widely adopted elsewhere.

If it is almost inevitable that these controls will be maintained throughout this first transitional period, then the central problem of statesmanship will be to use them in such a fashion as will best serve the common welfare. If their use is predicated on the assumption that it is possible for nations to hoist themselves into Utopia by their own tails, then the future outlook is little more than a gloomy compound of commodity agreements, clearing agreements, exchange controls, and quotas administered by an ever-growing bureaucracy. If, on the other hand, these controls are intelligently administered, either with a view to their gradual abandonment, or to their adaptation to the service of some kind of over-all world economic planning, then we may be able to create an order in which controlled trade may provide us with what the classical economists believed we could obtain from a world conversion to the doctrine of *laissez-faire*. If we cannot dismount from the horse which we are riding, then we must somehow put a bit between his teeth and make him serve us. To do so, we must have wiser and bolder economic statesmanship than we have thus far had. There is no more important problem before us than the careful study of the ways in which these special trade controls may be made to serve as a mechanism for planned economic expansion.

PROBLEMS IN TRANSITIONAL PERIOD

As I see it, the problem confronting the United States in this connection, during this first transitional period, will be perplexing indeed. Even if we do forego all, or nearly all, return from our lease-lend help, our present position plus the inevitable outflow of our postwar capital investment will make of this country the one great creditor State in the world. Will we be prepared to follow a trade policy which will bring about higher prices here than elsewhere, and therewith the inevitable import surpluses without which world recovery will be impossible? Such a policy will bring heavy transitional losses to many industries and probably to agriculture. It cannot be politically popular, but neither the invisible items nor the possibilities of continuous reinvestment of exported capital can free us from facing up to the central problem of the relationship between creditor position and commercial policy. We attempted once to avoid this problem, but I do not see how we can do so a second time.

In another sense the commercial policy problem confronting Britain will be comparably difficult. With a burdensome debt structure and a population concentration which makes a large volume of foreign trade necessary for national existence, it would be understandable if British postwar economic policy should be directed toward an attempt to regain export markets by the extension rather than the abandonment of the much criticized Ottawa policy of preferences; in other words, by the most ruthless kind of economic warfare, developing bilateralism in a fashion, and to an extent, not unlike that practiced in the recent past by the Nazis.

To put the matter in another way, it will be very easy

indeed for both Britain and the United States, during this first transitional period, to fall into commercial policies which will poison, and quickly destroy, that close and continuous American-British cooperation which, alone, can provide the essential basis for the winning of the peace. Vision and courage of the highest order will be required if this pitfall is to be avoided.

INFLUENCES OF POLITICAL SETTLEMENTS IN RECONSTRUCTION

If this general view of the postwar world is not wholly wrong, we can conclude that the nature of the measures taken during the transitional reconstruction period will have a powerful influence in determining the volume and freedom of international trade in what we hope will be a prolonged time of peace and cooperation thereafter. Even more basic, however, will be the influences of the political settlement. We are all more than familiar with the much-reiterated criticism that the Versailles statesmen lost the peace because they concentrated their attention upon politics and gave too little thought to the economic results which would be produced by the political settlement. This view holds that omission was fatal because the political settlement was ultimately destroyed by forces which had their origin in the "economic consequences of the peace." Even though this picture of the shortcomings of Versailles has been accepted by many careful students of that ill-fated treaty, it does not follow that the concentration of attention at the future peace conference upon economic matters, to the subordination of political affairs, would produce any better settlement. Indeed, it seems to me that the nature of tariffs and tariff policy in the period after the time of settlement and reconstruction

will depend fundamentally upon the extent to which the political settlement has created a satisfactory condition of security. By way of illustration, let it be supposed that the war has been won, that Germany has once more been stripped of her armaments, and that, in some form or other, the promise of the Atlantic Charter has been implemented by the re-establishment of a system of numerous independent states in Europe. Let it be supposed, further, that no attempt to create a security system other than that resulting from the destruction of German aggressive power will be attempted. Finally, let it be supposed that, as in 1919, official, i.e. intergovernmental, collaborative agencies set up during the war are allowed to lapse, and our own state of opinion made it quite clear that this country would not accept any formal or standing security obligations vis-à-vis Europe or any part thereof.

Such a settlement would go far enough to create humiliation and resentment in Germany, but as before, it would not go far enough to impair, except temporarily, the gigantic military potential of that country. Germany's neighbors would fear her once more, would be convinced that in time the vigilance of the victors would be relaxed enough to permit, under the slogan of equality, the resurgence of German military power. In eastern Europe what Nazi geographers have referred to as the *Teufelsgrütel* of states from the Baltic to the Balkans would, as before, be torn between a fear of Soviet Russia and the fear of a resurgent and militant Germany.

If we should have this kind of a political settlement—I would not call it a system—the European states would once more be forced to attempt the achievement of a greater measure of individual security by improving the power of their national military establishments, by con-

cluding alliances wherever possible, and by pursuing a policy of autarchy which would foster, for military reasons, the re-establishment and maintenance of uneconomic but militarily important industries. As in the case of Nazi Germany, these states would channelize their imports, to a considerable extent, into military uses, thereby reducing their export potential. In the ensuing difficulties over inadequate supplies of foreign exchange, the cry of the "haves" and the "have nots" would again be raised and exploited by skillful demagogues.

What I am attempting to say is that, if no effort is made to provide international security except through the unilateral disarmament of Germany, we shall assuredly have a world in which the trade controls of the transitional period will be perpetuated indefinitely—and even intensified—as instruments of economic power politics, or economic warfare, and not as devices which can either be abandoned ultimately in the interests of freer trade, or at least be made to serve as instrumentalities through which international planning can operate to improve the lot of us all. Competitive bilateralism, and not the most-favored-nation clause, will prevail. Tariffs will, of course, be high, but they will be overshadowed by these newer and more effective types of trade restriction.

It may be argued that I have taken an extreme case as an illustration of my point, that the nature and character of future international trade controls will be largely determined by the presence or absence of some institutional arrangements for international security, but there is, as yet, no assurance that the political order will be greatly different from the one which I have just outlined.

If we wish to speculate further—and this entire paper is little more than that—there are some other aspects of the

problem which bear upon this relationship between a security settlement and future commercial policies. First, there is the possibility, which is implied in the Atlantic Charter, that the disarmament of Germany will be maintained by the victors "pending the establishment of a wider and permanent system of general security"—these same victors which have obligated themselves to endeavor "to further the enjoyment by all States, great or small, victor or vanquished, of access, on equal terms to the trade and to the raw materials of the world which are needed for their economic prosperity." I would assume that this pledge of the Atlantic Charter implies the intention of the United States and Great Britain to use the preponderance of world military power which they will have at the end of the war to provide, through some kind of collaborative action, for the maintenance of European security, and, further, that they expect to associate other peace-loving governments with them (in other words, to broaden the security base) as rapidly as is practicable.

This approach appeals to me as sound and realistic, but there are a great many "ifs" which cannot be overlooked. First, will it be politically possible for the United States to take some part in such a system? It is clear that if we attempt once more to wash our hands of Europe's affairs, and if Germany is not crushed beyond power of recovery, then there will be no security available in Europe except through an alliance between Great Britain and Russia. It may very well be that our withdrawal would leave Britain no alternative but this, and, needless to add, such an arrangement would not be received with welcome anywhere in eastern and southeastern Europe. Second, can assurance be given to the states of western Europe that an Anglo-American peace system is really the preliminary to

a future system which will be broadly international in character, and not merely a clever arrangement whereby a disguised Anglo-Saxon hegemony will be fastened permanently upon the Continent? Third, is it feasible for the British and ourselves to work out and maintain, immune from petty friction and tension, an institutionalized cooperation which will be much less than "Union Now" but much more than our formal diplomatic cooperation of the past? Our own Irish citizens may secede, and at least one self-styled great American newspaper may secede with them, but I, for one, believe that, petty considerations apart, American-British cooperation represents for us the one "wave of the future," the crest of which we may be able to ride to eventual safety.

If through wise statesmanship on both sides of the Atlantic there can be developed a security system which does implement the goal of the Atlantic Charter, which is "a peace which will afford to all nations the means of dwelling in safety within their own boundaries," a first basic limitation upon the future development of freer international trade will have been abolished. There remain, however, other politico-economic problems the solution of which will affect the future trade policies of all countries. The first of these relates to the future and further spread of industrialization. We all know that industrialization is spreading, and that a decade of war and depression has expedited this process. If this continues recklessly, fortified and sustained by ample and unregulated capital imports, we may see, especially in eastern Europe and in many parts of the non-European world, the mushrooming of new industries which will demand protection. If this does occur, some of the benefits resulting from an improvement in international security will be lost, because the drive toward au-

tarchy will be supported by powerful vested interest groups in each country. Experience has shown us how rapidly these vested interest groups develop behind the protection of trade barriers, and how very difficult it is to reverse the process.

In other words, should the peace provide for the planning of further industrial development, providing to that end for the controlled and planned administration of international capital movements? It is, perhaps, fairly simple to accept a general principle of this kind, but it is exasperatingly difficult to discuss its application to specific problems. For example, should the states of eastern Europe remain essentially agricultural, depending upon Germany and Britain for the bulk of their industrial imports, or should industrialization be encouraged in order to free these states from the danger of being drawn once more into a trade relationship with Germany which will make possible, even probable, the re-establishment of an economic *Mittel Europa*? If the security problem is solved, should the efficiently organized German economy be allowed to dominate these countries? Reversing the question, can the security of Europe be assured if Germany is allowed to achieve this economic domination?

If we can solve the security problem, should we drive resolutely toward the goal of the eventual abolition of special trade barriers, leaving each country free to maintain its own tariff system, and encouraging the widest equality of trade conditions by the abandonment of the principle of preferences? Or, alternatively, should we encourage the formation of great regional trading blocs, within each of which there will be virtually free trade or, at least, very great preferences? Such a plan, which has many distinguished proponents, envisages the strict and

permanent control of trade among the blocs. Of these two possibilities, I am convinced that the former, with all its difficulties, is the more practicable. Geography does not permit the division of the world into neat blocs of this kind. (Where, for example, would Africa and the Near Eastern regions fit into any such scheme?) Moreover, such a plan involves the liquidation of empires, and it would be fantastic to assume that this would be done except as a result of slow evolution. Further, it would give both to Germany and to Japan the substance of victory for which they are now striving, and such generosity on the part of the victors is scarcely to be anticipated or desired.

CONCLUSION

It may be my own professional approach, but I cannot avoid the conclusion that the problem of trade and trade barriers is essentially a problem of politics. The political conditions of the peace will determine the character of the economic program. In its turn the economic character of the peace will have a profound influence upon the successful operation of the political peace. Our problem is one of political economy, and an appallingly complicated and perplexing one it is. If we can survive the transitional period without building up agencies and practices which will jeopardize or handicap our long-range needs, and if we can solve the persistent problem of security, then, if we have imagination and courage, I see no reason why we should not have a large volume of foreign trade flowing without excessive impediment to consumer markets. We will not thereby bring back a vanished world in which a few industrial centers will supply the remaining portions of the world, but we will have a system in which the movement of goods will be dictated primarily by economic and not

by political consideration. Such an achievement as this would fortify tremendously any security system which we may establish. Thereby, and only thereby, can we hope to win a peace which will justify the cost.

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